FOREIGN AFFAIRS

JULY/AUGUST 1997

THE PENSION CRISIS
Is Privatization the Answer?

Yes: MARTIN FELDSTEIN *No:* RICHARD LEONE

The End of the Business Cycle?
STEVEN WEBER • PAUL KRUGMAN

Transforming the Military
WILLIAM ODOM

North Korea's Staying Power
MARCUS NOLAND

Fred Bergsten on Dollars and Euros, *Swanee Hunt* on Eastern Europe's Gender Gap, and Fixing Foreign Aid & Refugee Assistance

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FOREIGN AFFAIRS

JULY/AUGUST 1997
VOLUME 76, NUMBER 4

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Post-communism has been bad for women in Eastern Europe—their representation, employment, and safety have suffered. America must support women leaders and entrepreneurs for the transition to democracy and capitalism to be complete.

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Too often guerrillas pretend to be refugees and siphon off aid to continue their fight. The humanitarians whose help they count on should halt this abuse.

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After 50 years of independence, India appears to the world neither rich nor powerful nor principled.

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By 2030, Social Security payroll tax rates will rise to 19 percent—more than 45 percent including Medicare and Medicaid. In Europe, which faces similar challenges, the burden of entitlement expenses is already so great as to slow economic growth. The solution is to phase out Social Security and other pay-as-you-go programs and replace them with a mandate for all to put away savings in a mix of stocks and bonds. Under a privatized system, the same benefits would require contributions equal to just two percent of U.S. payroll. Not only would the elderly be safe from poverty, but for the first time people of low and moderate means would accumulate significant personal savings.

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Although privatization zealots backed by Wall Street have called for replacing Social Security with mandatory investment in stocks and bonds, their promised high rates of return do not accord with experience. Any form of private investment is much riskier than a government program—and in the end can be more expensive if the government must bail it out. For at least a generation, retirement taxes would rise, funneling money to private investors. With small adjustments, the current pay-as-you-go system can continue its historic success.

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Secretary Cohen's defense review is out, but the flaws in the Pentagon's military planning are still glaring. Haiti, Bosnia, NATO expansion, stability in Korea, keeping Iraq in check—all these are primarily army and air force missions. Yet the army has been reduced by about 40 percent, while the navy has been cut back far less and the marines hardly at all. Advances in technology make the marines' expeditionary role and the navy's aircraft carriers obsolete. Defense doesn't need more money; it needs to reallocate resources. As it stands, the United States is paying more for a military that can do less.

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The waves of the business cycle are becoming ripples. The recent American combination of minimal inflation and very low unemployment may not be an aberration, but the beginning of a new worldwide trend. Smarter government policy, globalization, changes in employment, advances in information technology, and emerging markets all cushion shocks and dampen the familiar boom and bust. The consequences for world politics and prosperity will be profound.

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Things may look bad, but North Korea can stagger on for a long time before it collapses. The famine there, limited information seems to reveal, is due not to shortages of food but to political decisions in Pyongyang. But unification would be so costly for South Korea—about $1 trillion over 10-25 years—and a mass southward exodus so debilitating that the South will instead try to prop up the North. China

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will provide food, and the United States fuel, while the North muddles through with a form of apparatchik capitalism similar to Romania's in the 1980s, in which officials channel resources to favored groups.

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Comments

SWANEE HUNT

Leaders of nongovernmental organizations meeting in Chisenau, Moldova, 1997

In Eastern Europe the transition to capitalism has been difficult for most, but especially for women.

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Women's Vital Voices

The Costs of Exclusion in Eastern Europe

Swanee Hunt

The advent of democracy in the former communist states of Europe brings both much promise and, as we are learning, much peril.[1] For millions, the complexion of life has evolved from red to rose-colored to raw. A monolithic nemesis has been replaced by a perplexing variety of threats to stability in this fragile region, with expressions of democracy frequently drowned out by the noises of intolerance and repression.

In this brave new world, the voices of women are vital to healthy social and political discourse. The dramatically low status of women in post-communist Europe is an issue that goes beyond the well-being of women per se to the fostering of economic development and democracy. American interests require that we help the region's women carve out their rightful place in the mainstream of society.

ON THE MARGINS OF DEMOCRACY

Life under communism was a far cry from the auspicious pronouncements of fair treatment for all comrades. After all, equal access to parliamentary charades, empty shelves, and substandard health services was hardly a boon. With the fall of communism, the trappings of gender parity fell away, exposing discrimination against women that had persisted in the totalitarian state. The transition to capitalism has been difficult for most, but especially for women.

While the particulars of women's status differ from country to country, patterns of marginalization exist: diminished labor market access, increasing vulnerability to crime, loss of family-oriented social benefits, and exceedingly low parliamentary representation. In many countries in transition the feminization of poverty has been striking. In Russia, 87 percent of employed urban residents with incomes under $21 a month are female; above earnings of $315 a month, the figure nose-dives to 32 percent. To an even greater extent than in the West, Eastern European women tend to be clustered in the low-paying professions. But during this period of transition, ever-more-blatant gender-biased hiring and promotion practices are becoming deeply entrenched; job advertisements frequently specify "attractive female receptionist" or

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Swanee Hunt is U.S. Ambassador to Austria.

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"male manager." In most of the new democracies, regulations prescribe early retirement for women, locking them into fixed incomes far removed from the free market.

Under the weight of gender-based layoffs, lower pay, and meager career opportunities, this downward spiral is accelerating. In Russia, women's wages slipped from 70 percent of men's in 1989 to 40 percent in 1995, and in most sectors women are the last hired and first fired. In Slovakia, between 1989 and 1993 women earned just over half what men did—although more women were university graduates. In Belarus, where the majority of specialists are female, women search for a job three times longer than their male counterparts.

The slower the economic growth, the more severe is women's disadvantage. Employment gaps between women and men are least apparent in Poland and the Czech Republic, which are thriving. In countries experiencing more difficult transitions, the gap is larger. In Ukraine, for example, women constitute 70 percent of the unemployed, and the trend is sharply worsening. The underlying rationale was distilled by Russian Labor Minister Gennady Melikyan in 1993: "Why should we employ women when men are out of work?"

With divorce rates on the rise, the failure to force fathers to pay child support also contributes to the impoverishment of women. Likewise, holes in the government social net of kindergartens, child care, health care, and pensions make life precarious for women, who are usually expected to shoulder 100 percent of family responsibilities. In a reversal of communist demands that women work alongside men in fields and factories, whether they want to or not, women are now being pushed back to hearth and home.

Complicating their situation even further, women in Eastern Europe are disproportionately vulnerable to rising crime. Trafficking in women, which is increasing exponentially, ravages the bodies and spirits of impoverished young women promised jobs in the West only to find themselves controlled by pimps. A distressingly unexceptional case is that of a Polish shipyard clerk recruited for a better-paying job as a waitress in Germany. The recruiter photographed her being raped, then threatened to send the pictures to her devout mother in Gdansk. There has been a tragic surge in such violations since the rending of the Iron Curtain. By 1993 there were an estimated 8,000 Polish prostitutes in Frankfurt alone.

The development of legal protections often taken for granted in the West has languished in many of these countries. In Hungary, there is no law against sexual harassment in the workplace, which a U.N. report describes as "virtually epidemic." In some villages in Serbia-Montenegro, brides are still bought and sold. In Bulgaria, the law demands a witness in order to prosecute a rape case, and no prosecution for spousal abuse is possible unless the wife has been killed or permanently injured. Women in Moldova report that their courts view domestic violence as a "private family issue," yet in neighboring

[1]For this discussion, Eastern Europe is defined as stretching east to Moscow and from the Baltics to Albania.

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Russia, where an estimated 80 percent of violent crimes take place in the home, 15,000 women are killed by their husbands each year.

Clearly women were not integral to policymaking before the transition to democracy. But as a new chapter of freedom is being written, they ironically find themselves confined to the margins. Although communist parliaments were little more than rubber stamps, women were at least visible, their presence ensured by state-imposed quotas. To some extent, that ruse was itself pernicious. Nevertheless, the pretense of representation has been replaced by today's transparent exclusion. Across the chasm of political upheaval, from 1987 to 1994 the percentage of women in parliament decreased from 28 percent to 6 percent in Albania, from 34 percent to 4 percent in Romania, and from 21 percent to 11 percent in Hungary. Parliament was 33 percent female in the Soviet Union, but in many of the newly independent states the figure is now under 3 percent. The same downward trend is apparent for women in top ministerial posts: representation in Albania, Romania, and Hungary declined from 6 percent, 12 percent, and 4 percent, respectively, to zero.

AT HALF STRENGTH

Forty-five years ago, U.N. Ambassador Eleanor Roosevelt pointed out to the General Assembly that "too often the great decisions are originated and given form in bodies . . . so completely dominated by [men] that whatever of special value women have to offer is shunted aside without expression."

What women have to offer is nothing less than essential elements of the infrastructure of political stability.[2] Economic disparity, social hardships, breakdown of the rule of law, and weakness in civil structures are all exacerbated by the exclusion of women from the core of society. For example, women in poverty raise children in poverty, children less likely to benefit from good health, good education, and good jobs—children whose own unstable lives in turn contribute to the instability of their communities.

New free-market economies are producing a wide gap between rich and poor citizens, creating class resentments. When women, who generally build small to midlevel companies, are not valued as a resource for filling out the middle class, they cannot fuel their countries' economies as reliable employees and innovative entrepreneurs. Eastern Europe urgently needs the same energy that has driven the U.S. economy: a quarter of the American labor force is now employed by women-owned businesses, which, in 25 years, have increased from 5 percent to 35 percent of all U.S. firms.

Looking outward, the continuing disparity between rich and poor European countries, exacerbated by the disregard of talented and highly educated women in post-communist democracies, also undermines regional stability. Just when their contribution is most needed to strengthen fragile economies, women are stumbling on their way to the mar-

[2]To describe the role or qualities of women, one must resort to generalities that do serious injustice to the differences among individuals. That said, one should not back away from thinking in gender terms, even though those categories can be misunderstood or misused.

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SWANEE HUNT

Living on the margins: Refugees in Gorazde, 1997

ketplace, overburdened with household responsibilities. Women report that, more than ever, they are preoccupied with just getting through the day rather than building the future.

The discounting of women actually contributes to lawlessness, and the reverse is also true: trafficking in women is fueling organized crime, creating a menacing new East-West link as traffickers enjoy an endless market, enormous profits, minimal punishment, and little risk of getting caught. Fledgling democracies are especially vulnerable to and destabilized by such lawlessness. Nor is this violence against women solely an issue of justice; societies cannot honestly support women as builders of the new economies while tolerating a market in which criminals sell them as commodities.

Although there are still serious gender inequities in Western Europe as well, the trend there is toward women's full involvement, based on the democratic principle that lack of representation in political chambers is a fundamental flaw. The widening variance in the evolution of women's roles creates a further divide between Eastern and Western Europe at a time when stability through integration is a continental goal.

Finally, extensive sociological studies, neurological research, linguistic analysis, and political polling support the premise that, whether due to nature or nurture, there are differences in the way women and men perceive and behave. Women have coalesced in new alliances—there were 40 women's groups across Bosnia in the middle of the war—and they have led

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in the development of nongovernmental organizations (NGOs), the building blocks of any civil society. Eighty-four percent of NGOs in the Czech Republic, for example, are now headed by women. Sometimes women's cooperation has significant political import. In a dramatic crucible, after Bosnian Serb forces seizing Srebrenica in July 1995 massacred thousands of Muslim boys and men, Bosnian Muslim women were asked if they could work with Bosnian Serb women also searching for missing loved ones. The women nodded, then added, "We are all mothers."

PROFITABLE INVESTMENTS

When President Clinton sent Vice President Al Gore to lead the U.S. delegation to the 1994 U.N. population conference in Cairo, he set a new direction for U.S. policy in support of the priorities of women. That theme was reinforced through high-level U.S. leadership both at the 1995 U.N. women's conference in Beijing and afterward, when the White House formed an interagency council, now chaired by the secretary of state, to track implementation of the commitments the United States had made.

With the eyes of the world on the United States, the active global presence of First Lady Hillary Rodham Clinton and Secretary of State Madeleine Albright is probably the most potent contribution to the empowerment of women worldwide. But we are also taking more concrete steps.

For example, understanding that investing in women provides both short-term and long-term gains, the United States is sharpening its focus on women's economic enterprises. The U.S. government can ensure that entrepreneurial education is directed to women, as with recent funding from the U.S. Agency for International Development (USAID) for management training for 5,000 women dairy farmers in Albania and women running former state farms in Russia.

Credit is also critical. With a 98 percent rate of repayment, microloans for women are an extremely efficient way to support women and restore damaged economies. One example is the Bosnian Women's Initiative, launched by President Clinton at the 1996 Group of Seven summit. Bolstering business ventures by women of all three Bosnian ethnic groups, the grant program increases the economic—and therefore social and political—role of women. The First Lady has become a strong advocate for microcredit, and the Organization for Economic Cooperation and Development recently sponsored a conference to explore the connection between growth-oriented economies and women-owned businesses.

In terms of crime, an increased American presence in global law enforcement must support the new foreign policy emphasis on women's full participation in society. The U.S. government is focusing on this European slave trade. As part of the effort to combat trafficking in women, the United States was an active observer at a 1996 meeting in Austria whose aim was to harmonize national and international policies and legislation.

Similarly, as we back such democratic institutions as free media, independent judiciaries, open markets, NGOs, and multiparty elections, our support can help advance women as journalists, judges, investors, entrepreneurs, activists, and elected officials. To that end, a July conference in Vienna under the auspices of

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the U.S.-EU New Transatlantic Agenda, "Vital Voices: Women in Democracy," will bring together 150 women leaders from post-communist states to develop strategies with 150 women from the West.

Finally, USAID has supported numerous NGOs developing women's leadership in Croatia, Poland, Russia, Albania, and Bosnia. As a corollary, local women leaders must be included in U.S. government events in Eastern Europe where issues are discussed, deals are made, and policies refined. That may mean more creativity in compiling American embassies' Rolodexes, drawing from new sectors where women are key players, such as NGOs, the free media, and independent judiciaries. Similarly, embassies can expand programs to energize promising female political leaders by selecting them for visitors programs to the United States. From decades of experience identifying talented young male leaders, we can project that our early encouragement will reap enormous long-term gains.

While each of these efforts is infinitesimally small compared to the overall activities of the U.S. government, they all represent progressive steps for the foreign policy community. To use Secretary Albright's formulation, "focusing on women is not simply the right thing to do; it is the smart thing to do."

RAISING THEIR VOICES

Even in the face of hardship, women in the developing democracies are not playing the role of silent victims. Many have not only survived the transition, but are central to the formation of a civil society.

Over the past century, the nonprofit movement was a training ground for women in the United States; likewise, today's NGOs are providing an opportunity for development of European women leaders. Founded in 1990, the Network of East-West Women links more than 1,500 advocates in over 30 countries. Such projects not only provide important analysis (the Center for Gender Studies in Moscow is a regional leader), but also work directly with women in need. For example, La Strada was formed by women in Poland to offer shelter and information, warning other women of the dangers of the trafficking trade. And in spite of Moldova's economic plight, its Women's Association has 27 chapters that provide charitable assistance as well as technical support to women starting their own businesses.

The disorienting transition has not kept outstanding women leaders from appearing as government ministers and heads of key national and municipal entities. Their numbers are few as they break through a thick glass ceiling impenetrable in the days of totalitarian rule. But once broken, that barrier can never be resealed.

Examples abound of women finding their voices in post-communist Europe, and what they're calling for is nothing less than a just and humane society. Those basic American values are the rich resonance fundamental to a free-market economy and stable democracy. As women echo our own values, it is in the United States' interest to magnify their voices.

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Feeding Refugees, or War?

The Dilemma of Humanitarian Aid

Ben Barber

The humanitarian aid that has flowed to refugees through international agencies since World War II is meant to feed, shelter, and provide legal protection from deportation or persecution to people fleeing conflicts. But this aid has often been twisted in such a way that it fueled conflict. In some cases the lure of aid has impelled militant groups to create huge refugee populations. Hundreds of thousands of Rwandan refugees spent two years in camps in Zaire controlled by Hutu militias before departing last November. They were caught in what is only the latest in a series of situations in which refugee aid has fed wars while attempting to abate their ravages.

Large numbers of refugees menaced by starvation and disease make for pathos and dramatic press that attract aid dollars from international humanitarian organizations and foreign governments. The aid that flows to the camps where the refugees are gathered can be skimmed by militants based in the camps, as well as local businesspeople and military and administrative officials of the host government. The packed camps, protected by international sympathy and international law, provide excellent cover for guerrillas and serve as bases from which they can launch attacks.

REBELS BY NIGHT

In 1945 the U.N. Charter laid out principles on refugees and humanitarian aid. Six years later the General Assembly established the Office of High Commissioner for Refugees to care for Holocaust survivors and others displaced by World War II. UNHCR clients now number 30 million, having increased by about two million a year for the last decade.[1] A plethora of human rights, medical, and other nongovernmental groups like Save the Children, Amnesty International, Human Rights Watch, Doctors Without Borders, World Vision, and CARE have become powerful advocates for refugees and others needing humanitarian aid.

BEN BARBER, State Department correspondent for *The Washington Times*, has also reported for the London *Observer*, *USA Today*, *Newsday*, and *The Christian Science Monitor*. In 1991 he directed a study for the Refugee Policy Group of the U.N. plan to repatriate over 300,000 Cambodian refugees.

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In dealing with refugee crises, aid workers generally see themselves as up to their elbows relieving the immediate human misery; political and military issues are for later resolution in capital cities by negotiators in suits. That there are militants among the refugees does not mean that all the civilians can be allowed to go hungry, aid workers reason. It is this instinct for compassion, among donors as well as workers, that militant groups rely on. In addition, although most of the aid workers are idealistic and underpaid, their organizations have carved out prestigious and profitable niches as suppliers, which can color their advocacy in crises.

Although much refugee relief money is raised from private sources, the biggest blocks of aid come from governments. In 1995 the United States contributed $383 million, the European Union $295 million, and Japan $151 million toward refugee aid, followed by other countries. During the Cold War, refugee aid became a government instrument in the struggle to contain communism. Anyone fleeing or opposing communism was likely to win Western asylum and aid. The United States liked to cloak at least some of its military aid to anticommunist insurgents as assistance to refugees. Since the collapse of the Soviet bloc, attempts have been made to redirect refugee aid back toward purely humanitarian goals, but some percentage still ends up with guerrillas.

U.S. and Saudi aid flowed in the 1980s to camps in Pakistan that housed three million Afghan refugees while serving as bases for mujahideen fighters battling Soviet occupation forces in Afghanistan. Fifteen thousand Soviet troops died, and two million Afghan civilians and mujahideen have been killed in fighting that continues even today.

During the 1978-91 conflict in Cambodia, the United States and other anticommunist nations funded refugee camps in Thailand that were bases for three Cambodian guerrilla forces fighting the Vietnamese-backed government—one of them the Khmer Rouge, whose murderous rule sparked the 1978 Vietnamese invasion. Some 50,000 Vietnamese soldiers died in combat or from malaria during the more than 12 years of fighting; the number of rebels killed remains unknown.

On several trips between 1982 and 1991 during which I visited all the Cambodian refugee camps along the Thai border, the unholy alliance between refugee aid and the resistance fighting the Vietnamese occupation army was apparent. Relief agencies delivered food, medicine, and other services to the Cambodian refugees by day. But at night, fighters returned to the camps to rest, eat the food and use the medical supplies the agencies had provided, sleep with their wives, visit with their children, and recruit well-fed young refugees. Aid workers would arrive the next day to find more young men vanished to the front lines and refugees who had dared to speak out beaten or intimidated.

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[1]Legally speaking, a refugee is one who crosses an international border to escape persecution, warfare, or other severe problems. There were 15 million refugees in the world in 1995, according to the U.S. Committee for Refugees, but 20 million internally displaced persons—refugees within their own country. Both groups are now eligible for humanitarian refugee aid, and thus vulnerable to manipulation by insurgents who would skim that aid.

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In the 1970s and 1980s Algeria supported, and the Green Crescent and other international humanitarian agencies helped supply, refugee camps for nomadic Saharoui people around Algeria's desert city of Tindouf. When I visited the camps in 1982, it was clear that they were controlled, through tribal front men, by the POLISARIO guerrilla movement, which was engaged in fighting Moroccan troops who had occupied the former Spanish Sahara. POLISARIO operated a small army of 5,000 to 10,000 fighters out of the camps. Nine years down the road, a cease-fire was put in place, but the refugees are still in Tindouf, awaiting a stalled U.N. election.

India allowed asylum and gave aid to Tamil refugees in its southern state of Tamil Nadu in the 1980s, fully aware that among the refugees were many militants of the Liberation Tigers of Tamil Eelam, a separatist group fighting a particularly bloody war against the Sri Lankan government. New Delhi sought to use the Tigers to destabilize the administration of Sri Lankan President Junius Jayewardene, suspected of being pro-American. But India created a Frankenstein in the Tigers. More than a decade later, the group continues to plague Sri Lanka.

Recent refugee aid to regions of southern Sudan where rebels have risen against the government and to Sudanese refugee camps in neighboring nations is believed to have prolonged the fighting. Says Larry Minear of Brown University's Thomas J. Watson Jr. Institute:

> In the first six months [in 1989], this aid prevented countless deaths from starvation and warfare. Yet more than five years later the war continues to victimize the civilian population. There is a growing realization that what is required first and foremost is not larger amounts of aid but rather augmented pressure for peace.

Many refugee analysts believe that aid has been substituted for political initiatives that would resolve the root causes of emergency migrations, be they war, ethnic conflict, famine, environmental damage, or economic imbalance.

In the continuing crisis in Africa's Great Lakes region, 1.5 million Rwandan and 300,000 Burundian refugees, most of them Hutu, fled to neighboring Zaire and Tanzania in 1994 after Hutu genocide against Tutsis had mobilized Tutsi-led rebels—who had been refugees themselves for decades in Uganda—to wage and win a civil war in Rwanda. The refugee camps in Zaire were controlled by ten thousand or more Hutu militiamen and former Rwandan army troops. From the camps, they launched attacks across the border against Rwanda's new Tutsi-dominated government. (The internal situation at the camps in Tanzania was the same, but Tanzanian troops prevented strikes against Rwanda.) France sent troops that protected the retreating Rwandan troops and militiamen and then backed them politically when they became guerrillas in the camps because it saw them as a possible vehicle for restoring a French-speaking regime in Kigali.

When Zairian Tutsis and other militants on their way to a takeover of Zaire smashed the camps last November, more than 500,000 of the inmates declined to follow the militias deeper into Zaire. Instead, they walked back home to Rwanda, telling reporters they had been held hostage for two years. Some claimed to be victims only because they were afraid of being blamed in the genocide against the Tutsis. But there is ample ev-

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idence that the guerrillas used physical and psychological coercion to keep them in the camps, including withholding news of the Rwandan government's promise of safe return and spreading propaganda warning that Tutsis would slaughter them if they tried to go back.

"This was more egregious than Cambodia," said Bob Devecchi, head of the International Rescue Committee, which supplied some of the sanitation and water services at the biggest camp near Goma, Zaire, under contracts with donor nations and UNHCR. "The way the camp was organized, it was militiamen who determined food distribution, access to hospitals. [Militia] police ran the camp. The refugees were more like hostages than refugees getting direct aid."

So blatant were the abuses in the camps that UNHCR for the first time allowed refugees in its care to be forced home—at gunpoint. Soon after the Zairian rebels drove the refugees out of Zaire, Tanzania compelled the 500,000 Rwandan refugees in its territory to leave, despite their fears about what would happen to them if they returned to Rwanda.[2]

The forced return of the Rwandans and the coerced return of reluctant Cambodians after the 1991 peace accord is in keeping with a change in attitude toward refugees. The welcome mat has not yet been pulled in, but there is a new hard line. Donors are tiring of endless refugee sagas. The first-asylum countries—neighboring countries that refugees first flee to—worry that refugee settlements will become permanent destabilizing pockets along their borders. Contributing to the newly tough attitude is the abuse and manipulation of humanitarian aid typified by the plight of the Rwandan refugees.

PRINCIPLES OF MORAL RELATIVITY

For two years in the Rwandan case, 13 years in the Cambodian, and nearly 50 years in the case of Lebanon, refugees have been maintained in a stateless limbo. Humanitarian sentiment being what it is, any guerrilla movement can co-opt international refugee aid for military, political, or even racist purposes so long as refugees are languishing in camps. In the dozen conflicts I've covered in Asia, Africa, Europe, the Middle East, and Latin America, the guerrilla leaders resorted so frequently to the following strategies for co-opting aid that they all seemed to have studied the same handbook of small insurgencies.

The first principle: Take on the semblance of victimhood. Refugees are consummate victims; therefore, persuade or coerce a sizable number of civilians to flee to a region within your country or in a neighboring country where your guerrilla force can control them yet hide among them. Hutu, Afghan, Palestinian, Nicaraguan, and other militants have stretched out their hands as victims and received humanitarian aid, then taken up weapons and launched wars,

[2]After the Rwandans, the most reported-on refugees and internally displaced persons of recent years have been the two million produced by the war in Bosnia. Humanitarian aid to some of them saved the Muslim faction from starvation in Sarajevo and Mostar so that it could live to fight another year. But aid was not a major goal or instrument of the conflict, which was a far wider one than the limited guerrilla conflicts in which humanitarian aid can tip the scales.

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terrorism, and other forms of violence that have affected millions of people over the decades.

To uproot people and transform them into refugees, guerrilla groups may use propaganda, intimidation, incitement to ethnic, religious, or racial hatred, or a combination of these. The Tamil Tigers of Sri Lanka demonstrate how to foment ethnic hatred to turn members of an integrated, moderate minority into refugees and radicalized militants. The Tigers' tactics have included terrorist murders of soldiers, incitement of Tamil youths to kill ethnic Sinhalese civilians and burn Sinhalese houses, and attacks on buses in which guerrillas separated out Tamil passengers and machine-gunned the rest. The Tigers have also targeted moderate Tamil leaders, intimidating them into silence or killing them to close the door on any peaceful resolution.

Ancient methods like burning villages and crops, salting fields, and killing livestock are used by both insurgents and governments to persuade people to flee their homes; land mines and rumors of poison gas are also effective. Rebels may provoke the enemy to such actions or they may carry them out against their own people, denying food and shelter to the advancing enemy and creating a useful refugee population at one blow.

The second principle: Seek the support of the first-asylum or host country by promising concessions in long-standing disputes over territory, trade, water, and the like, should your group win power. The Pashto-speaking Afghan mujahideen promised Pakistan they would drop claims on predominantly Pashto regions in northwest Pakistan. The Cambodians promised Thai generals Cambodian teak and gems. The Hutu promised Zairian President Mobutu Sese Seko's regime that they would replace the aggressive, English-speaking Tutsi government in Rwanda with a compliant, French-speaking one.

Third principle: Bring in CNN and other world media outfits and show them the refugees' plight, guarding against unmonitored interviews in which refugees could disclose elements of coercion. Reporters may bridle at the limits and report them, but will also be compelled, as journalists, to air footage showing starvation and cholera. Even half the story is news.

Fourth principle: Reject measures to alleviate the refugees' suffering unless they further your movement's aim. Only allow camps to be set up within striking range of the enemy. Do not permit civilian aid workers to control the distribution of food. Refuse to disarm.

Fifth principle: Establish total control over information reaching the refugees. Saturate the camps with reports of atrocities against refugees' ethnic or political groups back home. Keep refugees in the dark about offers of amnesty or invitations to return.

Sixth principle: Seek out foreign allies that can block diplomatic recognition of, aid to, and trade with the enemy, as Arab countries did with Israel to support the Palestinian cause. These allies can supply your movement with passports, cash, weapons, and a mouthpiece in world bodies.

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REFORM AID

Countering such strategies will require major changes in the international community's response to migration crises spurred by conflict. Can governments, the United Nations, and nongovernmental organizations (NGOs) such as the Red Cross refuse to play ball with guerrillas willing to allow tens of thousands to perish of cholera, hunger, and thirst? For Americans and Europeans who saw the televised images in 1994 of the smoky plain in Goma covered with 500,000 starving Rwandans—men and women wrapping the bodies of their children and their elderly in straw mats to hurl them into mass graves—a refusal to help would have seemed inhuman.

"What are we to do? Cut off humanitarian aid?" asks Dennis Gallagher, executive director of the Washington-based Refugee Policy Group. "I think you're seeing it's unthinkable."

The guerrillas in the camps in Zaire proved so noxious, however, that two of the most prominent relief organizations there—Doctors Without Borders and the International Rescue Committee—could not stomach the abuse of aid this time, and pulled out. Yet Bob Devecchi of the International Rescue Committee, who made the decision for his group, noted that U.N. officials immediately hired another NGO to administer the food handouts and other programs in the camps.

Guerrilla groups, knowing how difficult it is for relief organizations to deny aid, often thwart attempted solutions to refugee crises so as to assure themselves a steady flow of supplies. That happened in the Rwandan crisis, and in Somalia in 1992-93.

The situation in Zaire ended only when another group of guerrillas broke up the camps and sent the Hutu militiamen packing. A century ago, armies did not hesitate to apply this kind of ruthless solution. Demilitarization of camps should be a requirement for humanitarian aid, and if guerrillas would sooner see their people starve than surrender their arms, one alternative would be for some force to enter the camps and take the weapons away. Clearly, sovereignty questions arise here, especially since asylum countries often find it convenient to allow guerrillas to harass their neighbors. Even if that is not an obstacle, Western nations are unenthusiastic—particularly the United States, after the deaths of 18 American soldiers diverted from a humanitarian to a military mission in Somalia in 1993. Concerns about sovereignty have delayed the creation of proposed international rapid-reaction units under U.N. auspices that could deal with such situations.

If no one is willing to separate fighters from refugees and a cutoff of aid remains unthinkable, aid might be tendered in innovative ways that make its abuse less likely. It could be laid in a trail to lure refugees away from guerrilla control, or given only to women and children. Rations and other services could be reduced to make camp life even less pleasant. Camps could be moved away from borders, although this would raise host countries' concerns about permanent settlements. Addressing such concerns would mean totally isolating the refugees from the local community so that they would not get comfortable in the country. Host countries would have to receive solid guarantees that the refugees would be resettled in third

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countries if they did not return home within a specified period.

Beyond this, it is vital that fundraising be separated from aid disbursement. All refugee aid should flow into undifferentiated coffers for disbursement by UNHCR, the Red Cross, or other impartial agencies. Appeals for specific groups of refugees should be ended, since they reward those who can produce the most pathetic images for TV and print.

A second crucial reform is a legal bar against humanitarian aid from any party actively involved in hostilities, enacted through amendments to international conventions. If the United States pumped food through refugee camps to anticommunist fighters, the United Nations would label it war aid, with the censure and possible sanctions that implies for both nations providing it and nations allowing it to traverse their territory. The onus of becoming a virtual belligerent in a conflict would stop many nations from allowing militants living among refugees to conduct hostilities against a neighboring state.

Other possible tactics include scattering refugees to reduce militia control and giving refugees an accurate picture of the situation back home through education and test visits by small groups that report back to their fellow refugees.

Regionwide conferences such as the Cambodia Peace Conference in Paris in 1991 could be called to resolve situations involving refugees. These would hold accountable any party fueling a conflict. Furthermore, exposure of aid abuse in donor nations' press and parliaments puts pressure on governments that support guerrilla wars from afar. Congress, for example, blocked aid to the Nicaraguan contras after news reports roused public opinion.

Countries like Iran that lack a free press or electorate will be harder to deter from using aid to fuel war. Even in the United States, some will argue that the two million Afghans who died in a war fed by humanitarian aid were the price of stopping communism. Those prepared to kill and die for a cause find little logic or honor in separating aid from the violent actions they deem necessary. But unless means are devised to ensure that aid serves only humanitarian purposes, millions of genuine refugees may no longer find compassion and support generously available.

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India in the World

Neither Rich, Powerful, nor Principled

Ramesh Thakur

The end of the Cold War presented India with a stark choice. It could persist in an inward-looking policy that slid it further into international irrelevance. Or it could take a hard look at developing countries that had achieved success through outward-looking policies and gained diplomatic *gravitas*.

India failed the first test in the Gulf War, one of the defining events for the post–Cold War order. India's confused response—which included a unilateral peace initiative to Baghdad—based on a faded image of itself as leader of the nonaligned nations, succeeded in alienating both Baghdad and Washington without winning any friends. Being bracketed with Cuba and Yemen in a U.N. Security Council vote at war's end calling for Iraq's surrender was less than edifying.

Five years later, India repeated the policy mistakes. Last September the U.N. General Assembly approved the text of the Comprehensive Test Ban Treaty, which India had campaigned against, by a vote of 158-3. Only Bhutan and Libya joined India in rejecting the treaty. The next month, the General Assembly voted to fill five nonpermanent seats on the Security Council. India and Japan keenly contested the Asian vacancy. What was expected to have been a close vote, perhaps requiring several ballots, turned into a rout. Japan romped home, 142-40. The two defeats proved that, 50 years after independence, India is neither rich enough to bribe, powerful enough to bully, nor principled enough to inspire.

THE SOCIALIST LEGACY

India's failure to match East Asian growth rates has diminished its international influence over the last three decades. Prime Minister Jawaharlal Nehru (1947-64), armed with socialist faith in an interventionist state and an aristocratic disdain for consumerism, tried to transform India into a giant of heavy industry. The achievements were genuine and substantial. India's economy grew three times as fast during the 1950s and 1960s as during

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RAMESH THAKUR, head of the Peace Research Centre at the Australian National University in Canberra, is the author of *The Politics and Economics of India's Foreign Policy* and *The Government and Politics of India*.

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British rule. The food security that Nehru worked for contrasts with recurring famine under the raj. In just 40 years, infant mortality was halved, life expectancy nearly doubled, and adult literacy almost tripled.

Even so, four decades of state-directed economic planning brought slow growth, rising unemployment, and growing dependence on imported capital goods and technology. Compared with developing countries in East Asia, India fared badly. Its share of world output and exports fell, and even quality-of-life measures on which a socialist government could have been expected to concentrate lagged far behind those of East Asia.

A major balance-of-payments crisis in 1991 gave the government of P. V. Narasimha Rao (1991-96) the opportunity to overturn the Nehruvian consensus on central planning and Fabian socialism and institute economic reforms. The pace of reform was brisk from 1991 to 1993, but inaction since then is catching up with India. The government deficit hovers around 6 percent of GDP, as unproductive spending continues for debt service, market-distorting subsidies, inefficient public sector enterprises, and unneeded civil servants' salaries. India's competitiveness ranking, according to the World Economic Forum, slipped from thirty-fifth in 1994 to forty-fifth in 1996.

Palaniappan Chidambaram, finance minister in the United Front coalition government that assumed power last year, has taken East Asia, where selective state intervention in the economy has met with much success, as the benchmark for fiscal reforms and trade liberalization. The 1997-98 budget simplified, rationalized, and lowered personal, corporate, and excise taxes, and widened the tax base. The government repealed the Foreign Exchange Regulations Act. Top tariff rates were slashed from 50 percent to 40 percent, and the government promised to bring them into line with Association of Southeast Asian Nations norms by 2000.

But reform is incomplete. Privatization has not even begun; meanwhile, public sector share of GDP, less than one-tenth in the 1950s, rose to around one-quarter in the 1990s while absorbing about half of gross investment. Microeconomic reforms have yet to be tackled. Labor laws discourage firms from closing unprofitable divisions. Barriers to imports of consumer goods must be removed, the banking sector strengthened, and government regulation reduced.

Washington has identified India as one of the ten big emerging markets, but development will require enormous investment. Infrastructure is woefully inadequate—congested roads, lethargic seaports, daily power failures, broken telephone lines. The energy sector needs an $80 billion infusion. Doubling telephone access nationally, to a modest two phones per 100 people, will cost $12 billion. Not all of this money can be raised in the country.

Yet foreign investment last year was only $2 billion, against a target of $10 billion; by comparison, China attracted about $40 billion. New Delhi woos investors with tax concessions, but its slow pace on developing business regulations and on allowing the price mechanism to determine resource allocation, along with many other obstacles, frustrates those attempting to get projects off the ground. The debate in the cabinet be-

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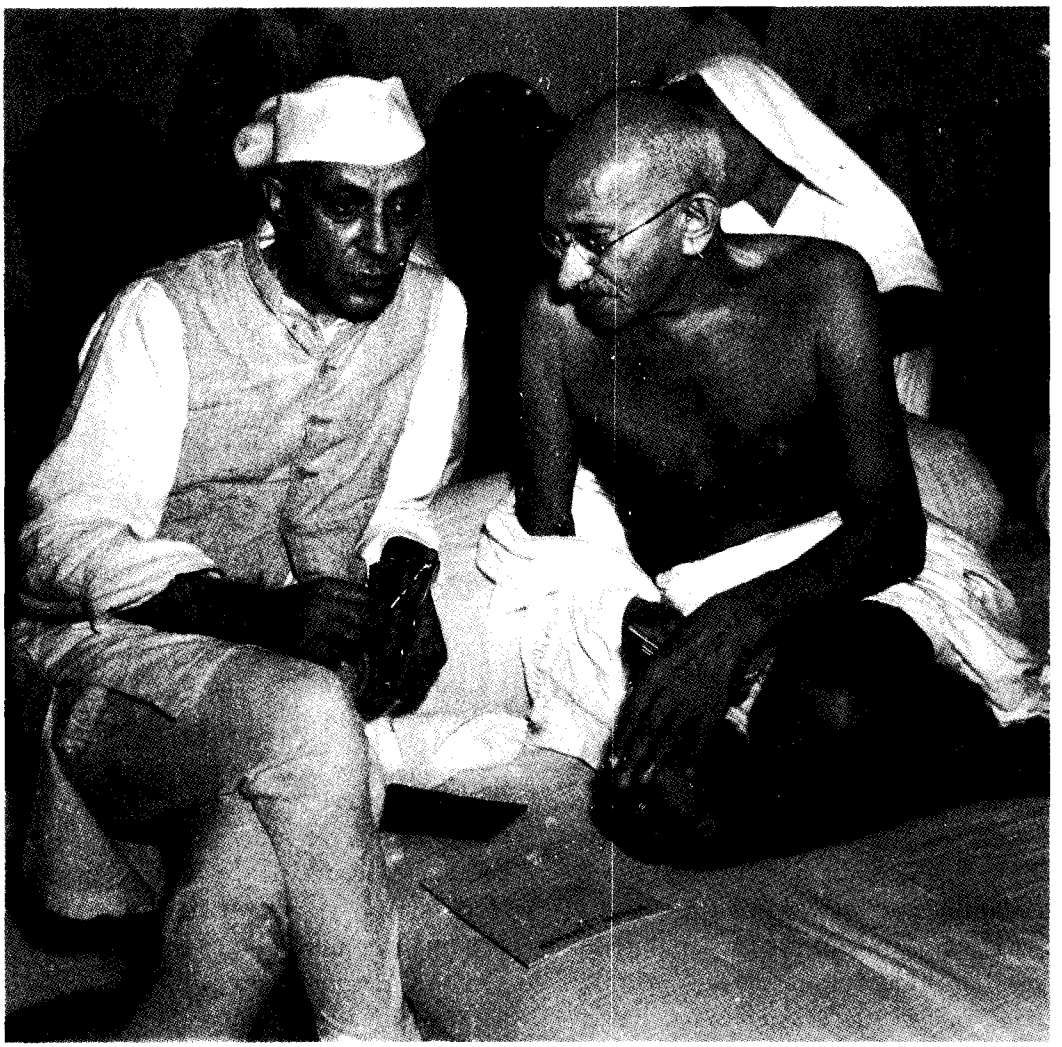

CORBIS-BETTMANN

Nehru and Gandhi contemplate India's future, Bombay, 1946

tween free traders and economic nationalists has left analysts and prospective investors confused and wary.

The culture of subsidies remains entrenched. Loss-making state enterprises soaked up $459 million in subsidies last year, against the $190 million budgeted. The effective power subsidy to farmers this year is $6 billion, up from $5.3 billion a year ago. A reduction in oil subsidies, although economically necessary, is considered politically suicidal. The government instituted food grain subsidies for poor families in December after admitting that the poverty rate was probably more than twice the official 16 percent.

Annual GDP growth is still healthy, at 7 percent, but that level is unsustainable without further reforms. The government should launch a frontal assault on the cost of doing business in India to improve global competitiveness. Current compliance and transaction costs—not to mention the necessary bribes—are steep. And the country is a long way from offering a sophisticated financial and services center.

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If instead of worrying about poverty reduction India concentrated on wealth creation over the next half-century, the poverty problem might just take care of itself. And since today's international balance of power is fundamentally determined by economics, if India became the economic and technological powerhouse it has the potential to be, it would not have to pursue the chimera of nuclear weapons.

POWER PLAY

India cut a sorry figure at the start of the 1990s, wracked by economic stagnation, political turmoil, and social ferment. The socialist legacies of the Nehru era were holding the country back. The V. P. Singh government (1989-90) pitted Indian against Indian with its policy of caste-based set-asides in government jobs and college admissions. Conflicts with Pakistan and China were debilitating preoccupations. The collapse of the Soviet Union left India alone on the world stage.

The Rao government accomplished much in addition to a few busy years of economic reform. It tried to repair relations with South Asian neighbors, moved toward more normal ties with China, made fresh starts with Russia and other former Soviet republics, and rebuilt bridges to the United States. As the United Front foreign minister, I. K. Gujral (who was sworn in as prime minister in April) gave top priority to improving relations with fellow South Asian nations through both unilateral and nonreciprocal concessions.

India's obsession with the nuclear option, however, threatens to undermine that progress. Most countries have become convinced of the futility of nuclear weapons. Russia and the United States have reversed the nuclear arms race. In indefinitely extending the Nonproliferation Treaty in 1995, some 180 countries—India not among them—declared that nuclear weapons were a debased currency of power. Since then, Southeast Asia and Africa have adopted their own regional nuclear-weapon-free zones, so that virtually the entire southern hemisphere is covered by such zones. Japan is a world power without benefit of nuclear weapons, while nuclear brinksmanship wins North Korea no power, prestige, or friends.

Indians, however, having stood on the threshold of nuclear weapons capability for 20-odd years and still stuck in a suspicious, belligerent worldview, seem to regard nuclear weapons as the major coin of world power. India deeply offends many countries when it implies that everyone else has been duped by the nuclear powers. The Comprehensive Test Ban Treaty will end, totally and forever, nuclear weapons testing and the associated health and environmental risks. And it will stop the development of new generations of nuclear weapons. The verification system, which involves national intelligence capabilities, a global network of seismic monitoring stations, and international inspections, will ensure against violations.

Signing the treaty would not take away India's option of maintaining a rudimentary nuclear-weapons capability. It *would* rule out the development of a sophisticated capability—which India could pursue only at the cost of a three-way nuclear arms race with Pakistan and China, among other repercussions. India's gravest security threats, moreover, are rooted in internal social and economic problems. Nuclear weapons are no use in combating terrorism by insurgents in Kashmir, Punjab, Assam, or Tamil Nadu.

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Had India decided to acquire nuclear weapons after its first test of a nuclear device in 1974, by now the world would have come to live with it as the sixth nuclear power. Instead, it must bear the opprobrium of being a nonproliferation and test ban rejectionist without having acquired nuclear weapons.

PRINCIPLES LOST

Perhaps the most important role that India—the world's most populous and the developing world's leading democracy—has to play in world affairs is as an exemplar. The corruption scandals of recent years, which culminated in the May indictment of former Prime Minister Rao for vote-buying, have left Indian democracy soiled, its citizens disillusioned, and its image abroad tarnished. Yet it is heartening that the flaws of India's rulers were exposed by India's democratic institutions, particularly the press, the judiciary, and opposition parties; to that extent, constitutional government in the country has been vindicated.

Other principles underpinning India's authority and role in world affairs are also in question. Secularism is a necessary element of the Indian state and needs renewing, while nonalignment is completely outmoded and should be jettisoned.

Secularism

With the December 1992 destruction of the sixteenth-century mosque in Ayodhya by Hindu nationalists, India plunged into its worst outbreak of communal violence since partition in 1947. Almost 2,000 people were killed and 5,500 were injured, two-thirds of them Muslims. Thousands fled their cities. International investors had a fright. The convulsion was symptomatic of pervasive governmental decay: in a religious community with no history of zealotry, the appeal of fundamentalism had grown as the moral authority of the Indian state declined.

The British policy of divide and rule hardened sectarian divisions, especially between Hindus and Muslims. It was the British who introduced communal representation, elevating religious identity above all else. Leaders began to construct political coalitions along communal lines.

The partition of the subcontinent into an Indian and a Pakistani state did not solve the problem of religious minorities. Although Hindus accounted for more than four-fifths of the population of independent India, there were significant numbers of Muslims, Christians, Sikhs, Buddhists, and Jains. To protect the rights of religious minorities, secularism was entrenched in the constitution. There is no state religion in India. No religion is accorded special privilege or discriminated against.

In time, however, some parties began to attack Nehru's legacy of religious tolerance as appeasement of Muslims. During a period when the Rajiv Gandhi government (1984-89) needed to shore up Muslim electoral support for the Congress Party, new laws, constitutional amendments, and policies appeared that seemed to demand the Hindu community's adherence to secularism, but not that of other religious groups.

Riding the crest of Hindu revivalism and exploiting Hindus' sense of grievance, the Bharatiya Janata Party (BJP) has been the major beneficiary of the attenuation

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of secularism, increasing its seats in the federal parliament from two in 1984 to 162 in 1996. Polling data show that support for the party is strongest among educated, urban, upper-caste Hindus.

The BJP, however, has gone about as far as it can with its hard-line policy of *Hindutva,* or Hindu-ness. The challenge now is to broaden its appeal by moderating its policies without creating disaffection among core supporters. The challenge for the more centrist Congress Party is to regain the trust of the Muslims, lost after Ayodhya. The challenge for the Indian government, regardless of which party is in power, is to return to the inclusive vision of Nehru, which accommodates the legitimate rights and aspirations of Muslims without alienating Hindus. That will require policies that promote secularism without pandering to fundamentalist elements of any religion.

Indians of all faiths must accept the reality of their history and take care to preserve it rather than trying to rewrite it. Indian culture is an amalgam of the cultures of successive waves of invaders. Contemporary India and Indians would be unrecognizable if somehow Muslim Mughal and British Christian India could be expunged from the collective unconscious. If Muslims are not permitted to integrate into the mainstream, a major new terrorist movement will feed on the resentment of the country's largest minority. Separatist sentiment and geographically localized violence in Punjab and Kashmir have caused trouble enough for the Indian state. In addition, an unresolved Muslim problem at home will damage India's relations with Muslim nations near and far and undermine its standing as an exemplar of democratic pluralism.

Nonalignment

To the extent that Indian foreign policy, often episodic and reactive, has any conceptual underpinning, it is to be found in nonalignment. India was a cofounder of the Nonaligned Movement in 1955 and has played an influential role since then. But after 50 years it is time to shed that magnificent obsession.

Nonalignment began as a prudent approach to India's foreign policy after independence, recognizing the need for mutually beneficial relations with as wide a circle of countries as possible. Its rejection of ideological blinkers averted domestic division and enlarged the portion of the world insulated from the chill of the Cold War. Nonalignment enabled Indian leaders to bestride the world like colossi, and imbued the Indian people with pride in a role befitting their country's greatness. The 1970s were the golden age of nonalignment and its accompanying agenda of radicalism at the United Nations.

The Nonaligned Movement was tied to the Cold War; great-power rivalry and conflict was its context. But now the threat of strategic nuclear war has abated, the superpowers have ceased their competitive interference in the Third World, and colonialism and apartheid have been vanquished. India is no longer a "new" country. Nor does it need to fear American pressure to declare itself once and for all on the side of the capitalist West, for the West has won the ideological battle, no doubt about it.

Far from seeking foreign assistance from non-Western sources for a growing

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public sector, these days India wants to prune a pampered public sector, attract foreign capital, and expose the formerly protected private sector to international competition. After decades of spurning multinational firms, India, like most Third World countries, wants to attract them.

Nonalignment distracts India from the real issues as it prepares for the 21st century: fostering regionalism in South Asia, normalizing relations with China and Pakistan, improving ties with the United States, building relations with the vast Asia-Pacific region, rebuilding relations with the successor states of the Soviet Union, and making its economy more market-friendly. The Nonaligned Movement may straggle along for some time, but it has lost even its nuisance value. It is simply irrelevant.

India's "principled" opposition to the Comprehensive Test Ban Treaty is likewise caught in a time warp. Whereas its argument in the 1960s that the Nonproliferation Treaty discriminated against the nonnuclear states was principled, and appreciated even by those who disagreed with it, India's hawkish position on the test ban—insisting it be linked to a timetable for total disarmament—is seen as sophistry and outdated power politics. The treaty meets many of India's long-standing concerns, and Indians' understandable irritation at U.S. hypocrisy in preaching nonproliferation while practicing deterrence should not be allowed to stand in the way of approval. India's signing of this universal and nondiscriminatory pact, every clause of which applies equally to all countries, should have been the crowning achievement of the campaign against nuclear testing that Nehru began in 1954.

THE FORCES CONVERGE

Following China's lead, India should explore ways to augment its market presence so as to expand its influence in world affairs. India has generally seen itself as a world power in the making and conducted its regional and international relations accordingly. It would do better to first improve its own economy and political stability. It must adopt economic policies that tap the considerable entrepreneurial flair of its people rather than impeding them, spurred on by the thought that nothing destroys the legitimacy of a political system like economic failure, while economic success reduces factionalism and helps keep politics and society on an even keel.

Regionally, the conflict in Kashmir is the main impediment in both India and Pakistan to cutting defense spending and converting defense industries to more productive civilian lines. (Almost 30 percent of Pakistan's and 15 percent of India's central government spending goes for defense.) Maintaining enmity toward China has also exacted significant opportunity costs. Improving relations with China would allow India to focus on Pakistan.

War-weariness in both Pakistan and India makes the time propitious for a resolution of the conflict in Kashmir. Pakistan's industrial and entrepreneurial class, the political constituency of the new Pakistani prime minister, Nawaz Sharif, is interested in economic ties with India. The new Indian prime minister, I.K. Gujral, is also an advocate of cooperation. Talks between the foreign secretaries, suspended for more than three years, resumed in March. Gujral and Sharif held cordial talks in the Maldives in May, the first meeting in four years between the prime ministers of India and Pakistan. Amicable relations would enable

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the two principal nations of South Asia to lead the way to regional prosperity, which in turn would help define the terms of the integration of South Asia with the rest of the Asia-Pacific and the world.

The economic crisis of 1991 forced India into much-needed economic reforms. The diplomatic crisis of 1996 should be turned to similar advantage. India should chart a radically new passage for the next 50 years, confident enough of its own worth not to scapegoat others, with the wit to grasp the new levers of power and the grace to deal sensitively with smaller neighbors. Prosperity, power, and principles will then converge.

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Essays

The shift between workers and retirees is real, and the sooner adjustments are made, the better.

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The Case for Privatization

Martin Feldstein

THE MARKET WORKS

GOVERNMENTS AROUND the world now face the daunting challenge of a rapidly aging population. Although the baby boom generation has accepted this change in demographics, the problem is not transitory. The combination of better medical care, higher standards of living, and improved lifestyles is permanently and irreversibly increasing the fraction of the population over the age of 65 and, even more rapidly, of those over 75 and 85.

This aging of the population means higher government costs for pensions and medical care. In the United States, the Congressional Budget Office estimates that under current law, the combined cost of Social Security retirement benefits and government spending on health care for the aged would increase from 10 percent of GDP now to 18 percent in 2030 and would go on rising after that. To pay for that 18 percent of GDP by raising taxes would require the equivalent of doubling the personal income tax or raising the payroll tax rate from 15 percent to more than 35 percent.

The situation in Europe is even worse. While the United States will see the ratio of persons 65 and over to those aged 20 to 64 rise from 21 percent in 1990 to 36 percent in 2030, the change in Germany will be from 24 percent to 54 percent. The Organization for Economic

MARTIN FELDSTEIN is Professor of Economics at Harvard University and President of the National Bureau of Economic Research.

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Cooperation and Development projects that government retirement benefits (excluding health costs) will exceed 16 percent of the GDP of Germany, France, and Italy by 2030, compared with about 7 percent of GDP in the United States. Although total health care costs are a smaller share of GDP in Europe than in the United States, the European governments' larger role in financing health care means that health spending requires more taxes. The high labor costs that result from high payroll taxes encourage businesses to substitute machinery for jobs and to shift production out of Western Europe. High payroll tax rates in combination with high effective minimum wages have thus been an important cause of the rise in European unemployment rates from less than half the U.S. level in the early 1970s to more than twice its rate today. The European economies may already have increased government spending and taxes to the point where economic activity and employment cannot continue to expand.

Raising future tax rates even further to pay for the benefits embodied in current law would do great damage to the American and European economies. However, cutting benefits enough to avoid a tax increase would mean a significant decline in the relative living standard of the aged and a failure to take advantage of future medical advances. The reductions in pension benefits that are politically possible and morally justifiable and the feasible savings in medical care costs that could be achieved by improved incentives would still require an enormous tax increase. Responsible government officials have therefore concluded that the current system of financing retirement income and health care cannot continue unchanged.

The problem with the current system is that retirees' benefits are financed on a "pay-as-you-go" basis, by taxing concurrent employees. The obvious solution is to shift to a privatized system of pre-funding those benefits through mandatory contributions to individual accounts. The increased savings during working years that such a system of individual accounts entails and the productivity of the resulting increased capital stock would permit future retirement and health care costs to be financed with much lower annual contributions than would be required under a pay-as-you-go system. Moreover, people of low to moderate means would for the first time accumulate large amounts of personal savings.

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A system of mandatory individual accounts has already been adopted to finance old-age pensions in Australia and several Latin American countries. Sweden has permitted individuals to shift a portion of their annual payroll tax contributions into private accounts. The British government has reduced the relative value of its basic state pension and earlier this year suggested dropping its pay-as-you-go system completely in favor of mandatory retirement savings accounts. Japanese Finance Minister Hiroshi Mitsuzuka recently suggested that Japan end its current pay-as-you-go pensions and provide a combination of a low flat-rate benefit for everyone and mandatory private savings accounts. In the United States, the official Advisory Council on Social Security issued a report earlier this year with three alternative sets of recommendations, each of which called for some form of pre-funding Social Security obligations by investment in private financial markets.[1] Although there has been no explicit official discussion in Germany, France, or Italy about substituting such accounts for the current national pay-as-you-go systems, only individual funded accounts can provide the portability and labor mobility envisioned in the 1986 Single European Act's attempt to create a single European market for labor and products.

SOCIAL SECURITY'S REAL PROBLEM

BEFORE DESCRIBING how a pre-funded system would work, it may help to clarify the nature of Social Security's financial problems. Social Security pensions and disability insurance are financed by a separate payroll tax of 12.4 percent on wages up to a current maximum taxable level of $65,400. The government now collects about 20 percent more from this earmarked payroll tax than it spends on Social Security benefits. The program is thus in surplus, which reduces the size of the federal budget deficit. The excess collections are formally invested in U.S. government bonds that constitute the Social Security trust fund. But by 2015, according to government actuaries, the aging of the population will cause Social Security benefits to exceed tax receipts. The program will then start running deficits that will exacer-

[1] *Report of the 1994-1996 Advisory Council on Social Security,* Washington: U.S. Government Printing Office, 1997.

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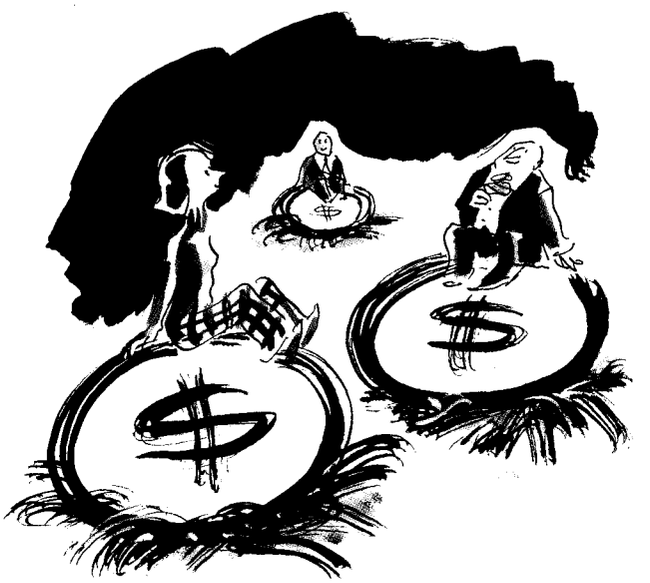

bate the overall federal budget deficit. After that time, the Social Security program will finance the gap between benefits and taxes by selling bonds now held in the trust fund to the public. By 2029, all of those bonds will have been sold, and the program will technically be bankrupt. Maintaining the benefits specified by current law would then require raising the payroll tax rate immediately from 12 percent to 16 percent and then gradually increasing it to a long-run rate of 19 percent after 2030. (Projected Medicare and Medicaid health spending on the aged would bring the total payroll tax rate to more than 45 percent.)

Although talk of the looming Social Security bankruptcy has helped promote interest in fundamental reform, in this context the notion of bankruptcy has no real substance. Social Security is said to be heading toward bankruptcy only because it uses earmarked taxes and has a trust fund. Other federal programs like education and defense have no earmarked taxes and no trust fund and would therefore never be perceived to be bankrupt. Social Security will only be bankrupt and unable to pay benefits if taxpayers grow unwilling to raise taxes to pay for those benefits, a prospect that becomes increasingly likely as political support declines for what is becoming understood to be a costly and inefficient program.

The trust fund is only an accounting mechanism with no economic meaning. When benefits begin to exceed receipts in 2015, the government must borrow to finance the shortfall. That borrowing will take

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the form of selling Treasury bonds to the public. It will absorb savings that would otherwise finance private investment in business plant and equipment, thus reducing investment and productivity. It will not matter whether the bonds that the government sells were previously in a trust fund or are newly created.

The problem with the Social Security program is not its prospective financial bankruptcy but that it has become a bad deal for participants. Social Security is now enormously expensive and provides a paltry rate of return on the funds that employees contribute. That low return undermines political support and makes continued reliance on Social Security very risky for future retirees.

The increasing cost of Social Security reflects the growing longevity of the population and the increasing ratio of retirement benefits to wages. Because the ratio of retirees to workers is increasing by more than 50 percent, causing the ratio of retirement benefits to taxable wages to reach 19 percent, the pay-as-you-go Social Security payroll tax rate is heading from 12 percent to 19 percent.

Social Security was once a better bargain. Between 1940 and 1980 the payroll tax rate increased from 2 percent to 10 percent, allowing benefits to rise sharply and to exceed greatly the taxes that individuals paid during their working years. Social Security was a wonderful deal for those who got in on the ground floor in the 1940s, 1950s, and 1960s. The double-digit rates of return that they earned on their tax contributions lent Social Security widespread public support. But those days are gone forever. The relation between the taxes and benefits projected under current law implies a rate of return of only 1.5 percent, and even that low rate is projected to decline.

WHAT PRIVATIZING WOULD DO

ALTHOUGH SAVING during working years is the natural way for individuals to finance the expenses of their own old age, not everyone has the necessary foresight and discipline. In a privatized Social Security system based on mandatory contributions, individuals (and their employers on their behalf) would be required to make contributions to individual savings accounts (like the popular 401k plans) that would be invested through mutual funds into diversified portfolios of

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stocks and bonds. At retirement, most of the accumulated balances would be paid out in the form of annuities.

For most Americans, mandatory contributions to individual savings accounts would represent additional savings that would add dollar for dollar to national savings and capital accumulation. Although some people may reduce other savings in order to maintain consumption, the vast majority of Americans do not have other savings to reduce; half of American households at age 60 have accumulated financial assets equal to less than six months of earnings. The new savings would flow into investment in business plant and equipment. The interest and dividends earned in those mandatory accounts would also be saved until the individuals reach retirement age, adding further to the national savings available to finance new business investment.

Two percent savings could eventually replace 19 percent payroll taxes.

Over the past four decades in the United States, the real (net of inflation) rate of return on such investment has been slightly more than nine percent. That will undoubtedly sound high to those accustomed to lower returns on their individual savings. The difference reflects the big bite that taxes take out of that nine percent return before it reaches individuals. Corporations pay 40 percent of the return as taxes to federal, state, and local governments, reducing it to 5.4 percent. That is just about the return that a "tax free" investor (like a private pension, IRA, or 401k account) would have earned over the past 40 years by investing in a portfolio of stocks and bonds. But the government could rebate to each account the extra 3.6 percent it would collect in additional tax revenue from the profits earned on the increased stock of business capital.

In contrast to this nine percent return based on the productivity of the capital stock, contributions to a pay-as-you-go system earn a much lower return equal to the rate of increase in tax revenues resulting from the growth in incomes and the labor force. As noted above, pay-as-you-go Social Security contributions now earn an implicit return of about 1.5 percent. That return will decline to 1.1 percent over the coming decades as labor force growth declines further.

A funded account that earns a nine percent real rate of return can provide for retirement income at a fraction of the cost that would be

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required in a pay-as-you-go system. To get a sense of how big this difference would be, think about a 45-year-old (in the middle of his working years) who earns $40,000 a year. At the current 12.4 percent tax rate, he and his employer now pay $4,960 annually in Social Security taxes. With a rate of return of 1.5 percent, that $4,960 would grow to $7,753 when the man is 75 years old (in the middle of his retirement years). In contrast, in a funded system with a nine percent rate of return, accumulating that $7,753 at age 75 would require saving only $584 at age 45. In short, the $4,960 tax in the pay-as-you-go system could be replaced by $584 of savings or, equivalently, the 12.4 percent tax could be replaced by a mandatory savings contribution equal to 1.5 percent of earnings.

Although this is just a rough calculation, it captures the potential gain from shifting to a pre-funded system. In a recent study at the National Bureau of Economic Research, Andrew Samwick and I used census and Social Security data to calculate the mandatory contribution that would be needed to replace the payroll tax in the pay-as-you-go system to maintain existing benefit rules.[2] We found that with a 9 percent rate of return, the 19 percent payroll tax that would eventually be needed could be replaced by a mandatory contribution of only 2 percent of taxable earnings.

A comparable gain could be achieved by pre-funding health care expenditures for the aged. The projected long-run cost of 12 percent of GDP would require a separate payroll tax of 30 percent in a pay-as-you-go system but could be financed by mandatory savings of only about 3.5 percent of earnings in accounts that earn the full pretax real rate of return.

THE IMPACT ON THE ECONOMY

SHIFTING SOCIAL Security pensions from a pay-as-you-go system to a funded program based on individual accounts would gradually lead to a substantial increase in the nation's stock of investment in plant and equipment, raising total national income, real wages, and the general standard of living. Although the mandatory savings

[2]"The Economics of Prefunding Social Security and Medicare Benefits," NBER Working Paper, in *1997 NBER Macroeconomic Annual*, ed. Ben S. Bernanke and Julio Rotemberg, Cambridge: MIT Press, forthcoming.

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rate would be a small fraction of each individual's wages, total additional savings would be large because the nine percent return on the accumulated savings would also be saved until the individual reaches retirement age.

Samwick and I estimated that mandatory savings would cause the nation's capital stock to rise by about 12 percent after 25 years and by about 34 percent in the long run, after 75 years, when the new system is fully phased in. This investment would cause real GDP and average wages to grow more rapidly, raising both an additional 7.5 percent after 75 years.

More important, the combination of the higher real wage and the lower payroll tax in the pre-funded system would cause the real spendable wage income of the typical employee to be more than 37 percent higher than under a pay-as-you-go program.[3] Replacing the 19 percent payroll tax with a much lower mandatory savings contribution would also sharply reduce the marginal tax rate of the typical employee. Since high marginal tax rates distort all kinds of economic behavior in wasteful ways—discouraging work effort and risk-taking and encouraging the substitution of untaxed fringe benefits for taxable wages—reduction in marginal tax rates would further improve the efficiency of the economy and the real incomes of individual employees.

THE TRANSITION

ALTHOUGH THESE long-run gains involve an increased cost in the short run, it would be relatively small. Critics of shifting to a funded system often dismiss the possibility by saying that it would require the first generation to "pay twice," that is, paying to support current retirees while also saving for their own retirement. Since the payroll tax is currently 12.4 percent, that appears to imply that the current

[3]Each $100 earned under the existing pay-as-you-go system would be subject to federal and state income taxes of about 20 percent, plus a payroll tax of 19 percent, leaving $61 of spendable income. With a pre-funded system, pretax earnings would be 7.5 percent higher, or $107.50. After a 20 percent income tax and a 2 percent mandatory savings contribution, spendable income would be $83.85, more than 37 percent higher than $61 under the pay-as-you-go system.

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generation would be required to pay more than 24 percent. Fortunately, that perception is mistaken. The cost is more on the order of an additional 2 percent, with taxes eventually falling.

There are many ways of gradually shifting from the pay-as-you-go system to a fully funded plan at low cost. It is possible, for example, to maintain permanently the level of pension benefits specified in current law, involve no new government borrowing (other than eventually selling the trust fund bonds), limit the initial increase in the combined payroll tax rate and mandatory saving to 2 percent (to a total of 14.4 percent), and in less than 20 years reach a combined total of less than the current 12.4 percent. In the year 2030, when continuing the pay-as-you-go system would require raising taxes to 16 percent, the combination of the payroll tax and mandatory saving would be less than 7 percent. And in the long run, the mandatory saving required with a 9 percent rate of return would be only 2 percent of earnings.

A pre-funded system could offer a rate of return of 9 percent.

It is useful to contrast this two percent savings rate with the "two percent solution" of those who would preserve the existing pay-as-you-go system by adding about two percent to the current 12.4 percent payroll tax rate for the next 75 years. According to Social Security actuaries, that increase in payroll taxes would temporarily build up the trust fund enough to permit benefits to be paid by a combination of taxes and trust fund bond sales for 75 years. There are two important differences. In the pay-as-you-go solution, the tax rate remains at 14.4 percent for 75 years, while in the transition to the fully funded system it gradually drops from 14.4 percent in the first year to less than 7 percent after 35 years and to only about 2 percent after 50 years. Second, with the pay-as-you-go solution the tax rate would have to jump after the 75th year to 19 percent, while it would remain at about 2 percent with the funded program.

More generally, the small extra cost during the transition years must be compared with the adjustments that would inevitably be made if the current pay-as-you-go system continues. Congress is unlikely to wait until 2030 and then sharply raise taxes. A more likely prospect is gradual tax increases and perhaps benefits reductions before

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then. The typical current employee might well pay less in taxes and receive more benefits in a transition to a funded system than in a continuation of the existing pay-as-you-go program.

GOVERNMENT FUNDS AND PRIVATE ACCOUNTS

THE KEY advantage of pre-funding old age benefits is the high real rate of return available on increases in the capital stock. Achieving that nine percent return requires additional saving but does not require the savings to be accumulated in individual private accounts. The same gains could in principle be achieved if the government collected the increased savings and invested them in a portfolio of stocks and bonds.

Without extra savings and an increase in the nation's capital stock, nothing would be gained by shifting some of the existing trust fund from government bonds to private stocks and bonds. The trust fund's income would rise, but the income of the private pension funds and other investors that bought the government bonds sold by the trust fund would fall by an equal amount. There would be no net gain in national income. Moreover, getting the private sector to hold more government bonds would raise the interest rate that taxpayers have to pay on the entire national debt. This lack of real economic gain and the increased interest burden on taxpayers are the basic fallacy in the Ball plan, the proposal by the group of Social Security Advisory Council members led by former Social Security Commissioner Robert Ball to invest 40 percent of the existing pay-as-you-go trust fund in private securities.

With extra mandatory savings, a Social Security trust fund managed by the government could in principle finance future benefits with the same low mandatory savings as individual savings accounts. The government could keep separate account records for each individual, effectively treating the funds as a defined contribution plan with the investment decisions made by the government. Or the government could use the funds to finance a defined benefit plan that involved redistribution based on such things as years of work, family status, and income.

Why then would a system of individual accounts be much better than a government fund? There are three reasons. First, a large and

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growing government fund would undoubtedly tempt the government to run larger budget deficits, thus absorbing some or all of the additional savings and precluding the increase in the capital stock. That is already happening with the existing Social Security funds. Although the U.S. Social Security system is officially "off budget," the Social Security surpluses of the past decade have made it easier for the government to finance deficit spending. In the recent agreement to achieve a balanced budget in the year 2002, the projected surpluses in the Social Security program ($108 billion in 2002) are used to balance deficits elsewhere in the government. Although sophisticated budget analysts might see that the incremental retirement savings were being used to finance other deficits, the general public's focus on the bottom-line overall government deficit would make it very easy to dissipate the added funds. Past experience with putting Social Security "off budget" shows that accounting techniques cannot prevent this from happening. In contrast, if the new funds are invested in private accounts similar to IRAs and 401k accounts, they could not be used to fund an expanded budget deficit.

Investing some of the trust fund in stocks would bring no gain in national income.

Second, a government-managed fund would almost certainly take political considerations into account in its investments. Although advocates of the government fund now say that it would be managed without political interference, legislation to prevent the fund managers from investing in certain industries or in companies that did business in certain countries or that failed to meet certain standards of "good citizenship" in their employment and environmental policies would be likely. That has been the practice of many state pension investment funds, for instance with regard to companies that did business in South Africa, and in federal contracting, as with minority and small business set-asides. It is hard to imagine that Congress would not want to influence the investment of a multi-trillion dollar fund under government control.

Third, to the extent that the government simply "indexes" its fund (that is, invests it in all stocks and bonds in proportion to their value in the market), it would undermine the role of the capital market in channeling funds to the most productive uses. Active private fund

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managers invest in promising companies with good performance and sell the shares of those that are not well managed. That lowers the cost of funds for the good companies and helps them expand while raising the cost of funds for the poor performers, slowing their growth and making it easier for other firms to acquire them.

Because of the very large amount of funds that would be accumulated, the choice of how they would be managed is critical. Even without pre-funding Medicare, the mandatory pension funds would grow to be about 45 percent of the nation's capital stock exclusive of owner-occupied housing and unincorporated businesses. At a time when the world is moving away from state ownership, it would be a major mistake for the United States government to effectively nationalize almost half of American business.

PROTECTING THE POOR

OPPONENTS OF shifting to individual accounts raise two important questions: How would such a system protect low-wage workers and individuals with long bouts of unemployment who benefit from the redistribution of Social Security? How would individuals be protected from the risk of stock market declines?

A pure system of mandatory saving accounts would involve no redistribution. That is why some proponents advocate combining them with a tax-financed uniform benefit to all retirees. Such a universal benefit is, however, a costly and inefficient way of dealing with the problem of old-age poverty since most of the benefits would go to those who would have had high enough income without that transfer. When 20 percent of the population is over age 65, a transfer equal to two-thirds of the poverty line (as proposed by the group within the Social Security Advisory Council that favored individual saving accounts) would require a payroll tax rate of approximately 7 percent.

One simple and more efficient alternative would be to provide a supplement to the mandatory savings accounts of individuals at age 65 whose accumulated amounts are too low to support a satisfactory retirement annuity. Although there is no clear standard for a satisfactory annuity, one possibility is half of the median retirement annuity. In an

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earlier study, Andrew Samwick and I used individual earnings histories to evaluate the cost of achieving such a minimum standard. We found that, with a mandatory saving plan starting at age 30, about 19 percent of the accounts at age 65 would have less than half of the median value. The cost of bringing them up to half of the median value could be financed by a one-time tax of 4.7 percent on all mandatory accounts at age 65. Each individual could save enough to finance that one-time tax by raising his lifetime mandatory savings by 4.7 percent. For example, if the basic mandatory savings rate was 2 percent of payroll, raising that to 2.1 percent of payroll would provide enough additional accumulation to pay the tax that would bring all accounts up to at least half the median.[4] This approach would be vastly cheaper than a 7 percent payroll tax.

Many other ways of protecting the poor in a funded system are possible. The key point is that it is not necessary to have a universal benefit in order to guarantee a decent standard of living for all of the elderly and that a targeted approach can be used with relatively little additional taxes or savings.

More generally, one of the attractive features of a pre-funded system is that it can substantially increase the incomes of low- and middle-income individuals during their working years as well as in retirement. As noted above, the combination of a higher real wage and lower mandatory contribution can increase the typical employee's spendable income by more than 30 percent. In addition, if a smaller income gain is taken during working years, the level of retirement benefits can be made higher than they are projected to be under current Social Security rules.

The source of these gains is the creation of a large capital stock owned primarily by the 90 percent of the population with incomes below the maximum taxable income (currently $65,400), who currently save very little. This would represent an enormous change in the distribution of wealth as well as a major shift in the distribution of income in favor of people of low to moderate incomes.

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[4]Martin Feldstein and Andrew Samwick, "The Transition Path in Privatizing Social Security," NBER Working Paper 5761, 1996, forthcoming in Martin Feldstein, *Privatizing Social Security,* Chicago: University of Chicago Press, 1998.

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MARKET RISK

THE SOCIAL Security program today is a very risky "asset" for anyone who expects to depend on Social Security benefits as the primary source of retirement income. In the past 15 years, Congress has voted to effectively cut Social Security benefits by making benefits taxable, by subsequently increasing the fraction of benefits subject to taxes, and by postponing the age of retirement for anyone born after 1937. There is now widespread discussion of further reductions of "promised" benefits by changing the inflation adjustment, accelerating the shift in the retirement age, and taxing more of the benefits.

Participants in a pay-as-you-go system are always at the mercy of the political process. The political support that previously came from the program's popularity is declining rapidly as voters recognize that the return on their Social Security taxes has fallen close to zero. A 1995 Gallup poll found that about three-quarters of 18-to-34-year-olds and two-thirds of 35-to-54-year-olds had concluded that they would not get back as much in benefits as they and their spouses had paid in taxes.

There is no way to avoid the political risk to benefits inherent in a pay-as-you-go system. By contrast, the risks of market fluctuations of a funded system can be avoided by a relatively small increase in the savings rate during working years, effectively building up a financial cushion to absorb fluctuations in stock and bond prices.

Here is what the historical record teaches us. Over the past 40 years, the combination of the rate of return on a portfolio of stocks and bonds plus the corporate taxes paid produced an average real return of nine percent. Employees who save two percent of their earnings (up to the maximum taxable level under Social Security rules) and earn a nine percent rate of return would be able to draw an annuity equal to the benefits promised by current Social Security rules. However, although nine percent may be the expected rate of return, the fluctuations in stock and bond prices imply that the actual rate of return might be higher or lower. Someone who saved just two percent of wages would be equally likely to have too little or too much at retirement to buy an annuity that just matches the currently promised Social Security benefits. Moreover, during retirement the fluctuation in stock and bond prices could also reduce the value of the variable annuity below the expected level.

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To protect themselves from that uncertainty and to virtually guarantee having enough to fund the benefits implied by current Social Security rules, individuals would only have to increase their savings rate from two percent of earnings to three percent of earnings. That would build a sufficient cushion of extra savings to virtually rule out the possibility—less than one chance in 1,000—of not being able to fund the annuity. That implies that the government would take virtually no risk if it guarantees benefits equal to those projected in Social Security law to anyone who invests 3 percent of earnings in a diversified portfolio of stocks and bonds.

A POLITICAL OPPORTUNITY

THE FINANCIAL problems of the Social Security and Medicare systems that have attracted so much attention should be regarded as providing a political opportunity to undertake reforms that would be desirable even without the aging of the population and the financial shortfalls in these entitlement programs. The shift from the existing pay-as-you-go system to a pre-funded system based on mandatory saving can lead to a dramatic reduction in the future cost of the program and a dramatic increase in the standard of living of most lower- and middle-income individuals. It is difficult to think of any other policy that could produce such a substantial permanent rise in the standard of living of the vast majority of the population.

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Stick with Public Pensions

Richard C. Leone

GETTING USED TO IT

PEOPLE EVERYWHERE are living longer, filling leisure communities and nursing homes, and alarming public policy analysts. The widespread failure to die in a timely fashion has inspired countless predictions of political chaos and economic ruin in the industrialized countries. The large American generation born after World War II will have to cope, it seems, not just with the usual intimations of mortality, but also with the unhappy consequences of their longevity for their societies and indeed for their own children.

But a measure of caution is appropriate because, as Bismarck, often credited with inventing social insurance, noted, politics is not an exact science. Neither is predicting economic, demographic, and social trends. Fertility experts, for example, foresaw neither the beginning nor the end of the American baby boom. And 2030—the year of peak U.S. boomer retirement—is as far away from us now as 1964. How many, 30 years ago, could have predicted stagnation of wages, the decline in birthrates, the rise of computers, the fall of the U.S.S.R.?

The shift in the balance between retirees and workers is real, and the sooner adjustments in retirement programs are made, the smaller they will need to be. But the hit-'em-over-the-head-to-get-their-attention approach is having perverse effects. In the running-scared

RICHARD C. LEONE is President of the Twentieth Century Fund.

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politics of the 1990s, the insistence on revolutionary changes may frighten off officeholders who need the reassurance of knowing that incremental revisions can preserve the pension safety net. In fact, it would be foolish to react to longer life by throwing out the basic features of successful and popular pension programs.

Although the details of advanced nations' pension plans differ, all rely on pay-as-you-go public systems in which firms, current workers, and often general tax revenues provide support for retirees. Some of these programs, like Social Security today, accumulate partial reserves for the future. All require adjustment and fresh thinking. But, despite superficial appeal and powerful marketing programs mounted by special interests, the most radical suggestions—especially privatization of basic public programs and full funding of all future pension liabilities—are neither necessary nor, perhaps surprisingly, less expensive. Retaining pay-as-you-go systems and the existing intergenerational compact, with modifications, remains the best course for preserving domestic tranquillity. Although the scale varies by country, adjustments in pensions can generally be accomplished without cramping economic growth or adding to inequality and poverty. The question, therefore, is not, as alarmists would have it, one of economic feasibility, but whether the rich nations choose to insure growing numbers of elderly against want.

BEEN THERE, DONE THAT

AGING POPULATIONS in most countries are a consequence of two simultaneous demographic trends: declining or stable fertility rates and the steady extension of the life span. The combination of more old people and fewer children means that two sets of statistics have become important: the widely cited ratio of retirees to workers (the elderly dependency ratio, or the number of elderly per 100 working-age individuals 15-64) and the ratio of all dependents to workers (the total dependency ratio, or youths 0-14 years old and elderly per 100 working-age individuals). While it is well known that the former figure is rising, in the United States and Canada total dependency in 2030 will not be much different from 1960 levels. The dependency

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RATIOS OF DEPENDENTS TO 100 WORKERS

COUNTRY		YEAR 1960	1995	2000	2010	2020	2030
CANADA	ELDERLY	12.7	17.5	18.2	19.8	26.3	35.1
	TOTAL DEPENDENTS	69.8	48.4	48.8	48.8	56.3	66.9
FRANCE	ELDERLY	18.7	22.7	24.0	24.5	31.2	37.5
	TOTAL DEPENDENTS	61.3	52.7	52.7	51.1	58.5	66.7
GERMANY	ELDERLY	17.1	22.1	23.3	28.4	31.6	43.2
	TOTAL DEPENDENTS	48.6	45.3	45.6	47.7	51.1	64.7
ITALY	ELDERLY	14.1	23.2	26.0	30.3	35.9	47.0
	TOTAL DEPENDENTS	51.7	44.9	47.5	50.6	54.6	67.2
JAPAN	ELDERLY	8.9	20.3	24.0	31.9	41.6	43.6
	TOTAL DEPENDENTS	56.0	43.7	46.4	55.8	65.0	67.2
UNITED KINGDOM	ELDERLY	18.0	23.8	23.5	23.7	28.0	34.4
	TOTAL DEPENDENTS	53.6	53.8	53.4	51.1	55.8	64.5
UNITED STATES	ELDERLY	15.4	19.8	18.8	19.3	25.1	32.2
	TOTAL DEPENDENTS	67.5	52.9	52.0	49.7	56.0	64.2

SOURCE: WORLD POPULATION PROSPECTS 1994, NEW YORK: UNITED NATIONS PUBLICATIONS, 1995

ratios shown in the table reflect these trends. Germany and Japan, among others, will experience a greater rise in the proportion of elderly dependents than will the United States. The Japanese increase will be particularly rapid, with elderly dependents more than doubling by 2020.

In assessing the projected "burden" of more elderly, an even more general measure may be crucial: the ratio of all potential workers to all those not working. Today, 46 percent of Americans are in the labor force; when the boomers are all retired in about 2030, that number will decline slightly to 44 percent. In 1964, when the baby boomer population peaked, however, only 37 percent of Americans were in the labor force—a ratio considerably "worse" than can be expected in the 21st century.

Moreover, the real burden on workers is best measured by looking at the overall size of the pie and the resources available per person. In the 1960s baby boomers' parents had less income per capita ($12,195, in today's dollars) than Americans do now ($20,469) and, even under very modest growth assumptions, much less than the projected average in 2030 ($35,659).

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CLOSING THE GAP

THE BEST way to think about the issues posed by aging is to start with the basics about seniors in the United States. They are now 12 percent of the total population and receive, from all sources, about 13 percent of income. Assuming Swiftian solutions are out, the boomers' share of income, while it might be cut a bit, will also be approximately equal to their share of the total population when they retire. Thus, in 2030 seniors will constitute about 20 percent of the population and will probably receive a proportional share of income. To put this change in perspective, between 1970 and 1995, the share of national income for the richest 20 percent of American families increased from 41 percent to 47 percent.

Most workers retire without sufficient personal resources or private pensions to sustain a middle-class living standard; government provides the balance. All Group of Seven nations employ some variant of a package that includes pensions, health care, and disability and survivors' insurance. The United States' minimum old-age benefit, however, is well below the G-7 average, providing only about a third of median income, versus an average of over 50 percent in other advanced nations. The deduction from U.S. workers' paychecks for Social Security is 6.2 percent of the first $65,400 of payroll and is matched by an equal employer contribution. In Germany, by contrast, the workers' deduction is about 9.3 percent of covered payroll, in Japan about 8.25 percent. The payroll maximums are similar.

The scale of public-sector pension reform required depends in part on the other sources of income available for seniors, including personal wealth, private pensions, and continued job participation. Savings, of course, are the ideal source of old age support. High savings can finesse political issues and contribute to economic growth. Household savings in the G-7 countries currently range from a low of 5 percent in the United States and Canada to over 11 percent elsewhere. American baby boomers are currently saving about a third of what they would need to maintain their living standards in retirement. In 1994, the share of U.S. elderly income from all assets had fallen from a peak of 28 percent in 1984 to 18 percent, the 1974 level. Income sources for American retirees other than personal as-

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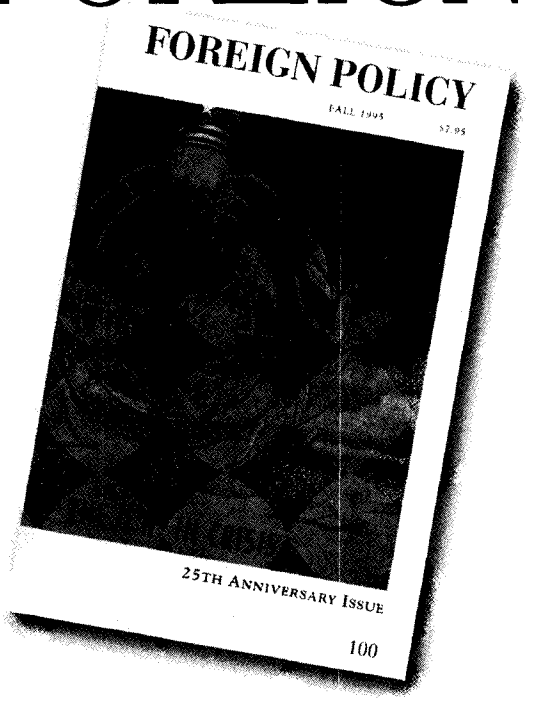

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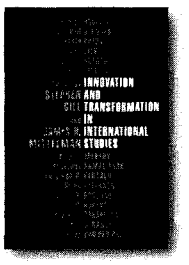

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sets are Social Security (42 percent), private pensions (19 percent), and earnings (18 percent).

Private pensions, not normally indexed for inflation, are an important source of senior support. There are persuasive calls for imposing a broad pension requirement on businesses; Australia, for example, has mandated company programs. Today less than 40 percent of American men are vested in a private pension fund, although participation is higher among older workers. The expansion of personal retirement plans, especially 401k tax-deferred payroll deductions, may be improving the picture and even increasing savings. Still, overall, the contribution of private pensions remains less than a quarter of total senior income.

Private pensions are not always a recipe for saving public money.

The British experience with personal pensions demonstrates that private plans are not always a recipe for saving public money. In 1986, the government encouraged contracting out of the State Earnings Related Pension Scheme by offering individuals reductions in national insurance contributions as a reward for participation in new personal pension plans. However, the British National Audit Office calculates that, because lost taxes have exceeded the reduction in pension liabilities, the program has resulted in a net loss of $9.6 billion. Britain also found that private plan sales agents captured an outsized share of worker pension contributions during the 1980s. Most troubling is an estimate that in 2030 the basic British pension will be worth a significantly smaller share of average earnings.

Like other countries, the United Kingdom has had to bail out several private pension plans. The 1991 collapse of the Maxwell publishing empire, for example, involved a loss of $880 million. This year Britain is increasing funding standards and enhancing government oversight of private pension plans. In the United States, public guarantees of private pension plans have been the vehicle for bailouts like that of the steel company LTV, which began in 1986 and cost $1 billion. On the plus side, the assets of private pension funds in the United States and the United Kingdom are now equal to more than 50 percent of GDP.

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Another possible area of relief for government programs is higher levels of senior participation in the work force. While those levels have stabilized recently, for most of the past three decades workers have been leaving the work force at earlier ages. In France, there is a growing movement to reduce the already low retirement age. In the United States, Britain, Germany, Italy, and Japan, however, the official retirement age has been slowly increasing. Left unanswered is the question of job prospects for older workers. Only the United States has a comprehensive law against discrimination based on age.

Another reform proposal, as recommended in the 1997 report of the U.S. Advisory Council on Social Security (ACSS), a 13-member panel of experts and business and labor leaders appointed by Secretary of Health and Human Services Donna E. Shalala in 1994, is that equities should be added to the investment portfolio of the Social Security trust fund. While diversification is a reasonable idea, it is being oversold. To simplify, the Social Security crisis is premised on U.S. economic growth declining to less than two percent annually, but this solution depends on a continuation of past high returns on equities. Some economists question whether stock values can grow indefinitely in a slow market economy at the same rate achieved in a high-growth environment.

Finally, higher economic growth, combined with other developments such as more rapid population increases, theoretically could ease the demands on retirement plans—high growth, that is, compared with the annual wage rise of one percent in the mid-level Social Security projection. In fact, under the assumptions of the "optimistic" official projection, the trust fund would enjoy a large surplus throughout the next century. Regrettably, there is no consensus on how to raise either savings or growth, or even how much would solve the pension challenge. Given stable or declining labor forces in most countries of the Organization for Economic Cooperation and Development, most growth projections are disheartening. Therefore, since the public sector will provide the lion's share of retirement support, the debate centers on the relative virtues of privatization and full funding versus modification of existing public pay-as-you-go plans.

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PRIVATIZATION

THE IMPLICIT argument for a pension revolution is simple: we're too generous. Seniors will get too big a slice of the pie. But given the actual income and asset profile of most seniors, the real question is whether we would somehow be better off with a lot of poor old people. Only seven percent of retired Americans maintain incomes of more than $75,000 a year. As the Concord Coalition stresses in its 1996 report, "The New Debate over Social Security Reform," half of American households have less than $1,000 in net financial assets; half of households headed by someone in their fifties have less than $10,000 in savings. Overall, median assets for all Americans are slightly over $50,000, including housing, a reduction, in real terms, since 1989. Are these the potentially savvy investors who, under privatization, will buy a share or two of stock a month (presumably at bargain, odd-lot prices) and pay their own way?

In general, privatizers advocate switching from publicly managed and guaranteed pay-as-you-go plans to some form of individual investment accounts. Normally responsible people often talk real foolishness about privatization—implying that all participants in the universal system of private accounts will consistently outperform the market. While any businessperson or money manager knows that he or she would go broke or to jail by promising a perpetually high, risk-free annual payout to all comers, many privatizers blithely put forward such expectations for all workers. Taken straight, of course, privatization means that how much one can save and how well one does in the market determines what one gets in retirement. Social insurance, such as that at the heart of Social Security, is either eliminated or funded from outside the system.

In the industrialized world, therefore, most serious proposals involve only partial privatization, retaining a minimal safety net (below the poverty level) for those who lose out as either workers or investors. The model often cited by advocates of privatization for the G-7 countries is a system adopted more than 15 years ago in Chile by the military dictatorship of Augusto Pinochet.

In 1981 Chile abandoned a theoretically fully funded plan that had been wiped out by runaway inflation and adopted mandatory indi-

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vidual employee retirement accounts. Workers have contributed 20 percent of earnings to the system—10 percent for investment purposes, 3 percent for administrative charges and disability insurance, and 7 percent for health care. There is no employer contribution. Investment accounts were managed by a handful of government-regulated private companies (Administradoras de Fondos de Pensiónes, or AFPs). Additional backup pensions are funded from general revenues. Active workers who switched to the new system were awarded service credits for past contributions. To ease the transition, Chileans also received an across-the-board 18 percent wage increase.

Full privatization could cost $6.5 trillion over the next 72 years.

The Chilean experience has demonstrated both the benefits of pension reform in a rapidly developing economy and the high costs of transition to privatization. The Chilean government's financial liabilities include large future pension obligations for retirees who participated in the old system, generous guaranteed minimum pensions (85 to 90 percent of the minimum wage), and additional pensions, like those for the military, which have not been privatized. The government has financed some of these costs through a budget surplus but has also borrowed, selling many of the new bonds to the new pension fund managers.

Although the overhead in the Chilean system has come down in recent years, the cost of administrative fees remains 13 percent of mandatory contributions. With 3.5 million contributors, AFPs employ 11,500 salespeople. Perhaps more to the point, since private pension investments are closely regulated, there is little justification for such high marketing and administrative expenses.

Chilean reforms have been touted as a success because, from 1981 to 1995, accounts yielded an average annual real rate of return of 12.9 percent. Recent returns, however, have been lower, and were minus 2.5 percent in 1995. Until the 1990s, virtually all funds were invested in special high-yield government bonds and bank paper. Despite the excellent overall performance of the Chilean economy, AFPs still have small investments in stocks—10 percent in 1990, 28 percent in 1996. Thus, the high returns are essentially due to high interest rates. Moreover, Chilean politics are relevant: the new system was imposed by a

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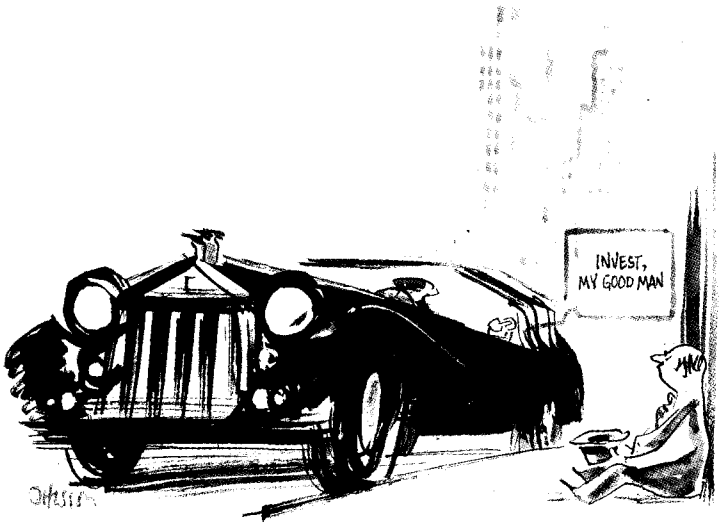

military regime after national labor unions had been outlawed. Finally, contribution evasion remains a problem, with some estimates suggesting that a quarter to almost half the work force avoid payments.

On the plus side, while some economists question the relationship, it seems reasonable to credit the forced deductions from disposable income for some improvement in savings. The new system is also properly praised for encouraging the development of financial and capital markets. Perhaps most important there is little evidence so far of the corruption and waste so characteristic of Third World systems.

For quite different reasons, in the United States and elsewhere, the push to privatize has considerable political and financial support. According to the December 23, 1995, *National Journal,* the Cato Institute has raised $2 million to promote privatization. The ACSS report included minority recommendations for full funding and privatization. Implementing these recommendations would not be cheap: one version proposed increasing taxes by $6.5 trillion over the next 72 years. But these advocates of privatization deserve credit for making explicit the requirement for higher taxes. Others who talk of privatization emphasize tax cuts in order to increase savings. But does anyone really believe that a worker earning $20,000 a year who received a cut in payroll taxes would have a 100-percent-plus propensity to save, saving the full amount of the cut and more, as would be required to increase net savings? Most fanciful of all are the privatizers who imagine a world in which individual savers capture the total return of

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the most productive companies, presumably pay no fees, and consistently exceed the gains of the stock market. Few privatizers mention the additional overhead involved. According to the January 7, 1997, *Washington Post*, actuary David Langer estimates that under the ACSS proposal favored by Wall Street, a system of individual accounts with a range of investment choices, management and administrative fees could total $240 billion from 1998 to 2010.

Social Security currently provides a larger share of senior income than it did in 1979; for 63 percent of retirees, it is the source of 50 percent or more of total income. The go-it-alone character of privatized systems disregards the dramatic success of programs like Social Security in alleviating elderly poverty, which has fallen from almost 40 percent in the 1940s to less than 12 percent today.

Another practical concern is what happens if, as in the 1970s, the stock market drops sharply. Imagine the political crisis if millions of new retirees were told, "Forget your middle-class dreams. The market went against you." The likely result of a market crash—as with busted private pension plans, savings and loans, and insurance disasters—would be a government bailout.

Given these realities, assuming privatization will work seems perverse. Privatizers' predictions depend on compulsion (higher taxes), fear (lower assured government payments), and universal market success. More likely, the result would be increases in need-based pensions and insurance. Regrettably, all privatization proposals fail to come to grips with the most fundamental reasons for public programs: market risk, wealth inequality, sluggish wage growth, and uncertainty about personal longevity.

PAY-AS-YOU-GO

IN THE G-7 countries, although all pay-as-you-go systems require maintenance, repair is cheaper than moving to privatized or fully funded systems. According to the ACSS, an increase of 2.2 percent of the combined worker-employer payroll tax would fix Social Security for the foreseeable future. On the other hand, when a nation makes a transition from a pay-as-you-go system to a fully funded one, it pays benefits to retirees who participated in the unfunded system while no longer receiving con-

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tributions from current workers, since they are contributing to the new, funded system. To finance benefit payments the government can raise taxes, cut spending on other things, or increase its national debt. In one way or another, a generation of workers will be asked to pay twice for Social Security, once in the form of higher taxes (or lower government benefits) to pay for the transition, and once in the form of a reformed Social Security contribution.

A higher payroll tax burden is tame compared to the Cold War.

Many comparisons between public systems (pay-as-you-go or funded) and private schemes miss a central point. Universal plans are not merely savings or investment vehicles designed to provide the best return. They pool the risk that all workers share—income shortfalls, market downturns, disability, and other misfortunes—and they provide basic support, usually in the form of a lifetime retirement annuity that offers a return equal to inflation plus the real increase in wages. They normally include an insurance component that provides income for surviving spouses and the disabled, the face value of which, in the United States, is about $12.1 trillion.

One oft-repeated argument against pay-as-you-go systems is that they discourage savings. But the evidence is mixed. Mandatory payroll deductions can reduce current consumption by workers, and a modified pay-as-you-go program running a surplus, like Social Security today, can contribute to net national savings. The compelling politics of senior support programs provide one of the few justifications for raising taxes rather than borrowing. In the United States during the strongly anti-tax era since 1970, for example, payroll taxes have increased on more than a dozen occasions. The much higher tax rates that would have to accompany a shift to a fully funded system, however, are simply politically impractical.

The other key arguments against public pay-as-you-go systems are that they no longer provide a fair return, that they will become too great a burden for those working, and that they will create destabilizing fiscal burdens for governments. With regard to the first point, a comprehensive review of recent studies leads the economists Yung-Ping Chen and Steven C. Goss to conclude that Social Security "provides exceptional money's worth. Program administrative costs absorb less than

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one percent of every dollar." Even excluding insurance value, the return, although less favorable for future workers, will still be "reasonable."[1]

With regard to the burden on workers, remember that total per capita GDP continues to increase and that total dependency rates in the United States and Canada will only return to 1960s levels. Moreover, when considering total burdens, future workers—heirs to the immense economies of the G-7 countries and to the capital accumulated by the largest generation in history—may be in an enviable position. The Great Depression, World War II, and the Cold War were somehow manageable for boomers and their parents. A larger pay-as-you-go pension obligation sounds a trifle tame in that company of generational challenges and is a small price to pay for that legacy.

On the fiscal risk point, the International Monetary Fund, police officer of government profligacy, recently published a study analyzing the coming gap in pension financing. After focusing on the relative cost of adjusting current pay-as-you-go systems versus moving to fully funded systems, the study concludes that U.S. and U.K. plans could stay solvent with modest increases in contribution rates. In 1995, the IMF calculated that the United States would have adequate funding through 2050 if it raised its contribution rate by 0.8 percent of GDP. How revolutionary would such a shift be? Well, as children, the baby boomers sparked an increase in the share of GDP devoted to elementary and secondary education from 1.4 percent in 1946 to 4.1 percent in 1970. The United Kingdom, according to the same IMF study, is in the best shape of the industrialized nations, requiring an increase in contributions of only 0.1 percent of GDP. Canada, Germany, Japan, Italy, and France would need more substantial increases of approximately 2 to 3 percent of GDP to avoid a buildup of pension debt. Other measures, such as raising the retirement age, lowering the income replacement rate, and indexing benefits to prices rather than wages, would reduce the revenue shortfall. Importantly, the IMF assumes reduced growth rates in all the nations under study—a range of 1 to 1.5 percent.[2]

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[1]"Are Returns on Payroll Taxes Fair?" in *Social Security in the Twenty-First Century*, ed. Eric R. Kingson and James H. Schulz, New York: Oxford University Press, 1997, p. 87.

[2]Sheetal K. Chand and Albert Jaeger, "Aging Populations and Public Pension Schemes," IMF Occasional Paper No. 147, 1996.

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The IMF also found that, over the next 50 years, changing to fully funded pension systems would involve large transition costs. If the United States made a gradual transition to such a system, it would need to increase its cyclically adjusted deficit, excluding net interest, to 3.4 percent of GDP, compared with only 1.5 percent of GDP to modify the current system. Similarly, to switch without debt accumulation, Germany, the United Kingdom, and Italy would need to increase their cyclically adjusted deficit by double the amount necessary to mend their pay-as-you-go systems. For all seven major industrialized nations, moving to a fully funded system would be more costly than modifying their current systems.

GROWING THE ECONOMY

IN MODERN democracies, any large group that is not self-sufficient is a source of political controversy. Sometimes the scale of programs involved bears little relation to their political significance. The welfare benefits of 14 million Americans, 9 million of them children, for example, have been at center stage of national politics for more than a decade, despite the fact that the dollars involved are less than one percent of the federal budget.

In this sense, the current pension debate is really about the prospects for income and wealth distribution. If recent sluggish wage and income growth and worsening wealth inequality were rectified, the transition to an older society would be easier. Of course, some argue that slow growth is inevitable because boomers will draw down assets in retirement and overall savings will decline. In the United States, pension savings are 3.6 percent of total wages today; they may be zero in 2024 and minus 3.5 percent in 2040. But, while aging may reduce household savings, the decline could be offset completely by lower demand for capital goods. Indeed, if current population projections hold, it will take no net savings to maintain a constant amount of capital per worker. Moreover, living standards can always rise because of technological change. Slow growth is not an inevitable byproduct of an older society. As the economists James Poterba, Larry Summers, and their colleagues put it, "A more definitive finding is the absence of any empirical support for the pessimistic view that aging societies suffer

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reduced productivity growth."[3] In fact, increased productivity growth of 0.1 percent per worker in the United States would completely offset the additional burden of an increased elderly population.

It is surprising, therefore, that there is not more debate over whether the G-7 nations have an iron destiny to grow less than 2 percent a year. Could future economic performance be enhanced by targeting investment to the young, perhaps reducing investment in health care facilities for the old? Couldn't we focus policy and resources on more savings, investment, training, and education to increase growth, rather than funneling premiums to Wall Street? The answer seems to be probably not, if such improvements require higher taxes. Another course is to expand the labor force through more immigration, but here too politics is an overriding factor. There is also a good case, if not a good political strategy, for more equal incomes, higher minimum wages, and other measures to make savings a more practical alternative for average workers.

There are many proposals, not dependent on growth, designed to work in combination to fix systems like Social Security: smaller income replacement ratios for upper earning brackets, higher taxation of high pension benefits, eliminating ceilings on taxable payroll, switching from wage-based to price-based adjustments, increasing the retirement age, and, in the United States, bringing millions of government workers, not currently covered by Social Security, into the program. All of these proposals, however, while sensible, depend on political will.

FACING UP

WITH THE demise of communism, there are no systems left standing that promise citizens equal economic results. Capitalism, now favored by most of the world for good reason, certainly does not make such a claim. Everywhere it holds sway, there are wide disparities in income and wealth. About 85 percent of all financial assets, for example, are owned

[3]"An Aging Society: Opportunity or Challenge?" Brookings Papers on Economic Activity, 1990, Vol. 1, p. 4.

[4]Benjamin I. Page and Robert Y. Shapiro, *The Rational Public: Fifty Years of Trends in Americans' Policy Preferences,* Chicago: University of Chicago Press, 1992, p. 120.

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by the richest ten percent of American families. There is a certain illogic, then, in prescribing, as privatizers do, a cure for elderly poverty of taking a little more of the market and calling them in the morning.

In the democracies, at least, there is a strong consensus that extremes of wealth and poverty do not make for a healthy society. Just plain compassion is still compelling for some, particularly toward the young and old. There is also a widespread belief that those who have worked should be assured of enough income in retirement to maintain a reasonable standard of living. It may be rational to frighten people about aging in order to scare them into saving more, working harder, getting more education, even supporting additional payroll taxes. But it is silly to claim that the private market can make everyone rich. Fortunately, the appeal of such notions can stand neither close analysis nor the test of politics.

Programs like Social Security remain enormously popular. According to the results of a Europe-wide poll published in the January 27, 1996, *Economist,* most voters think that their governments do not do enough for seniors. And, despite repetition of the canard that Americans have given up on Social Security, more than 80 percent of them believe that government must keep the program, and an equal number approve of their own continuing payroll contributions. Seventy-one percent would pay higher taxes to prevent cuts.[4] The unequivocal commitment to Social Security and Medicare by both parties in the 1996 campaign was not a result of ignoring the polls.

Given the alternatives, continuing support for current policies—with modifications—may not be a bad outcome. The reform of existing public pensions looks possible and prudent. The democratic process is not likely to lead, as some contend, to disaster, but rather to an acceptable result. The likelihood of periodic adjustments in the demographic and financial estimates is a reminder of the abiding virtues of muddling through. For those who would be distressed if privatization and all those new commissions and management fees fail to materialize, there is the consolation offered by John F. Kennedy: "If a free society cannot help the many who are poor, it cannot save the few who are rich."

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Transforming the Military

William E. Odom

MISSION MISMATCH

AMERICA'S DEFENSE does not require a larger budget, but rather a major reallocation to meet the challenges of the post–Cold War world. Facing up to this politically divisive issue will be difficult, but the subject ought to be aired before the contending parties fall back on the easy option of increased spending. The congressionally mandated Quadrennial Defense Review was issued in May, and Sen. Joseph Lieberman's (D-Conn.) amendment to the last defense bill requires a preparedness report to Congress. The QDR's recently announced recommendations include only trivial cuts in naval combatants and aircraft, a woefully disappointing result. Faulty rationalizations for inappropriate force structures have marred previous official reviews, including Clinton administration Defense Secretary Les Aspin's bottom-up review and Bush administration Defense Secretary Richard Cheney's base force concept. The same can be said of recently departed Defense Secretary William Perry's valedictory article, "Defense in an Age of Hope," in the November/December 1996 *Foreign Affairs*.

Perry espoused a U.S. strategy for managing conflict that rests on three lines of defense: preventing threats from emerging, deterring threats that do emerge, and defeating with force those that breakout into conflict. While in principle it makes excellent sense, as elaborated, Perry's analysis fails to address four serious problems: regional prioritization of U.S. interests, inadequate means for dealing with nuclear proliferation, a mismatch between missions and forces, and unexploited

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WILLIAM E. ODOM, Lieutenant General (Ret.), is Director of National Security Studies at the Hudson Institute and Adjunct Professor of Political Science at Yale University.

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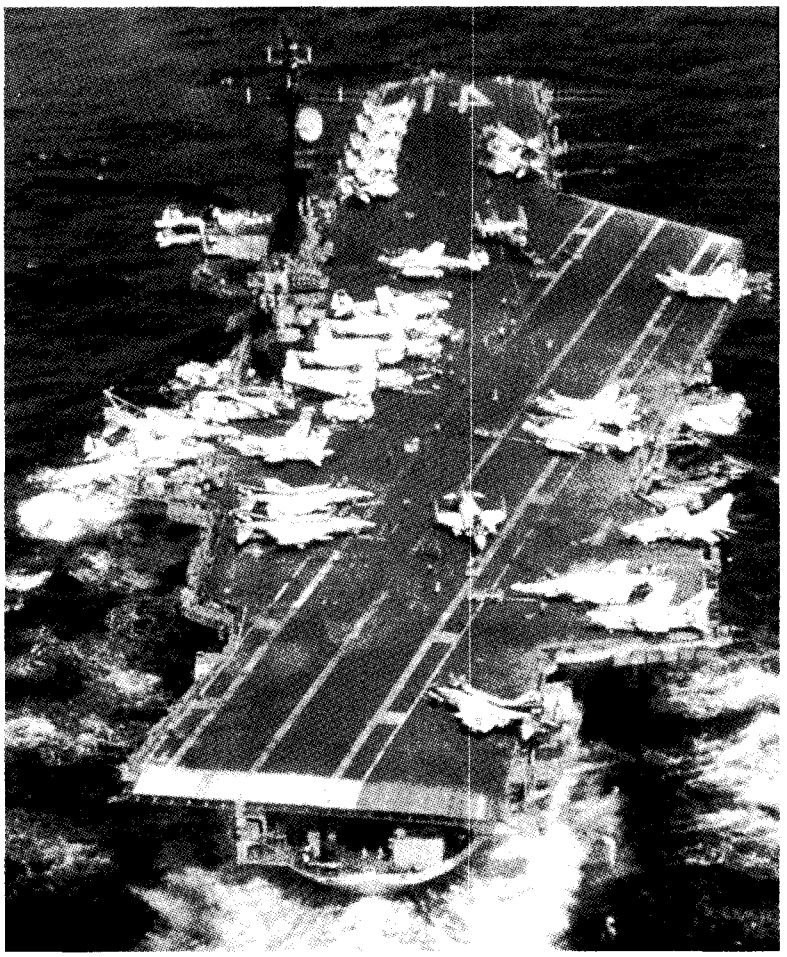

ARCHIVE PHOTOS

Changes in technology have rendered floating airports obsolete.

technology. Since Perry's article, Secretary William Cohen has released his report on the Pentagon's military planning and outlook. While Secretary Cohen's report identifies regions of importance and defines missions for each, it remains to be seen whether he is merely nodding at the notion of regional priorities or is willing to articulate significant change. The same flaws that blemished the Pentagon's planning when Perry left office are still glaring.

PREVENTION AND PROLIFERATION

THE FORWARD deployment of U.S. forces in the Middle East, Europe, and northeast Asia is no less critical now for the prevention of war than it was during the Cold War. Perhaps unintentionally, Perry

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appears to apply the preventive portion of his strategy to just about every region of the world. This broad view will be difficult to sell to Congress and the public, especially when it concerns countries in Africa, South Asia, Southeast Asia, and South America. By failing to prioritize among regions, Perry provides little idea about how to husband limited military resources, inviting isolationist criticism and internationalist disillusionment.

On the proliferation of nuclear weapons, Perry's approach is far from comprehensive. He stresses dismantlement of existing nuclear arsenals and extension of the Nuclear Nonproliferation Treaty. But what if these means fail, as they already have in several cases? By backing the Clinton administration's adherence to a limited theater ballistic missile defense, Perry only partially explains how a threat from proliferation, were one to arise, would be defeated.

While dismantling the Russian nuclear arsenal may be desirable, it is wholly impractical in the near future. Letting Russia's arsenal decay in its silos may prove a better approach. Moscow is too weak and its military and nuclear production bureaucracies too corrupt to spend the money provided by Senators Sam Nunn and Richard Lugar's 1991 Cooperative Threat Reduction Program. American dollars cannot substitute for Russian government oversight. No amount of money can make a dismantling program fully effective. Adding arms control measures and coercive diplomacy may close a few more holes in the counterproliferation net, but not all of them. A ballistic missile defense is the most compelling solution, not just for nuclear weapons but also for other weapons that can be delivered by ballistic missiles. Use of conventional military forces against existing nuclear weapons programs is another means of countering proliferation that should be considered.

MAKING MEANS MEET ENDS

THE MOST fundamental problem with Perry's approach is its gross mismatch between ends and means. Perry's list of means includes three major categories of forces: pre-positioned equipment afloat and ashore, carrier battle groups, and marine and air expeditionary forces.

Pre-positioned equipment makes a lot of sense for the Persian Gulf area. The same can no longer be said about projecting forces

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by naval vessels and carrier-based aircraft. Today, with aircraft technology permitting long-range flights, carrier-based air support is increasingly obsolete. It takes longer to deploy than air force capabilities and has only a fraction of the air strike capability at a much higher cost. An air force wing—about 70 fighter-bombers strong—can move from Germany or the United States into the Persian Gulf within 24 hours. Unless a carrier happens to be close by, it can require three days to a week to arrive. When it does, it provides about 40 ground attack aircraft that are far less capable.

The marines' approach to military missions is obsolete with today's technology.

Comparing the fiscal outlays makes an air force wing much more attractive, although getting accurate data is difficult. According to Defense Department planning for the next ten years, about twice as much will be spent to sustain carrier groups and their aircraft ($260 billion) as to sustain land-based tactical planes ($126 billion). About the same amounts for each will be spent on research and development, $19 billion and $18 billion, respectively. Carrier-based airpower is allocated $152 billion for procurement, roughly three times as much as the $56 billion for ground-based air power. The General Accounting Office has concluded that carrier costs are underestimated, perhaps by half. In any event, these numbers reveal an indisputable fact: a carrier-based aircraft is the most expensive way to deliver a bomb to a target. When aircraft could fly at most 300 miles round-trip, floating airports made sense. Today, when fighters and strategic bombers can fly across oceans in less than a day, the case for carriers is weak.

The typical answer to this awkward question of cost is that the United States does not always have air bases where strike aircraft are needed. However, that is not the case for any of the three key strategic regions—the Middle East, Europe, and northeast Asia—where U.S. military deployments make sense. Moreover, when the United States decided to strike Libya in the 1980s, two carriers in the Mediterranean Sea did not have sufficient capabilities to execute the mission. An Air Force F-111 bomber unit based in Britain was added to the strike force. Less well known, a plan to conduct the mission with B-52s, all based in the United States, was also developed. The

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mission could have been executed without carrier-based aircraft, adding a lot more bombing power for a fraction of the cost.

The case for the marines as an expeditionary force is no better. With the technology of wide-body aircraft construction and more efficient jet engine technology, the existing fleet of 20 C-17 and 80 C5A transports can easily lift army special operations forces anywhere in the world in less than 24 hours. They can seize an airfield in an hour or less, and within several hours an army tank company, possibly a battalion, can be landed by air. Within a day, more than 50 tanks can be landed if additional C-17s are procured as planned. Very few countries in the world could hope to contain, much less quickly defeat, that force once it was on the ground. Moreover, in two or three days it could be increased to a mobile force of a couple of hundred combat vehicles.

Marine forces must sail for days to arrive at their destination. Once they slog their way across the beaches, they are usually still far from a point where they could take decisive action against a capital or an inland concentration of the country's military forces. Except for the occasional use of modest amphibious forces, the marines' approach to expeditionary missions is obsolete, given today's military technologies.

Most contingencies demanding a rapid commitment of forces to distant places will not require the military units to fight their way in. The United States has allies in the three key regions, and if it cannot depend on some of them, then such deployments probably will not make sense anyway. Still, army forces, supported by air force tactical air and strategic airlift, offer by far the most effective expeditionary forces for the foreseeable future.

The major changes in the U.S. force structure since the Persian Gulf War have been reductions in army and air force capabilities. The navy's carrier fleet stands at 12, with a single carrier battle group costing at least an estimated $50 billion for a 10-year life cycle. The army's divisions, at $10 billion for a heavy division with a 10-year life cycle, have been cut from 18 to 10.

Moreover, only about $50 billion is allocated for procurement of army forces during the next ten years, compared to $152 billion and $56 billion for carrier and land-based air power. Meanwhile, the marines retain three active divisions and one reserve division. Marine spokespersons sometimes insist that a marine division is less expensive than an army

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heavy division, but the claim is deceptive. The navy budget pays for some of the marines' research and development, procurement, and training. More important, marines do not provide adequate logistics for operations more than a few miles inland. The army provides much of the logistics for marine units when they operate inland, as in the Gulf War. The army also pays for a large portion of the research and development costs for marine weaponry, as well as for some of the training. The true costs of marine forces for inland operations include sums spread here and there in the navy and army budgets. According to General Frederick Kroesen's calculations, marine forces cost about 25 percent more than equivalent army forces, which have far greater combat capabilities.

THE IRREPLACEABLES

IN ADDITION to assisting prevention and deterrence, forward deployments must also contribute to strategies for defeating enemies. The claim by the navy and marines that their "forward deployed" forces can accomplish the expeditionary mission for the "deter" and "defeat" components of defense strategy is largely based on legends of times past and ignores the vast improvements in air force and army expeditionary capabilities. As for prevention, it is difficult to imagine how carrier battle groups and marine expeditionary units, even if supported by strategic bombers, could perform the prevention functions of army units stationed in Germany, other NATO countries, and South Korea or the Fifth Air Force in Japan and South Korea.

If every carrier battle group in the navy's fleet were posted off the Korean peninsula, the entire armada would fail to provide as much "preventive" influence as the single army division and air force units deployed there now. When the comparative costs of the different forces are considered, it becomes clear that the United States would be paying more, not just for a less effective force structure, but for a counterproductive one.

Some observers believe that aircraft carriers were necessary to deter Chinese military maneuvers near Taiwan in March 1996. In fact, they were not. More airpower could be projected over the Taiwan Strait by the Fifth Air Force from Japan, and in the event of hostilities, much of this airpower could be deployed to Taiwan's air bases.

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Moreover, a much cheaper fleet of surface combatants could show the flag with the same effect as the carriers.

As for the marine deployment in Okinawa, it could be replaced by an army division or corps stationed in Hokkaido, giving the Japanese Ground Self-Defense Forces a U.S. military counterpart with which to train. While Japanese air and naval forces have U.S. counterpart forces to train with regularly, Japanese ground forces do not. The marines, in the view of Japanese officers, do not provide an adequate substitute since marine doctrine, operational procedures, and command structure are different from the U.S. Army's. Had the United States offered to halve the number of marines in Okinawa in exchange for basing an army division in Hokkaido, the Japanese government would probably have jumped at the chance. With additional strategic airlift in Japan, an army division in Hokkaido could be deployed in the region far more swiftly than the marines based in Okinawa.

The United States pours more and more technology into the navy's increasingly obsolete forces.

In Bosnia, the United States found that carriers and marines could not compensate for army divisions and air force tactical support. Ground troops proved essential for a lasting truce. Moreover, to claim that NATO air strikes brought the Serbs to the negotiating table is to overlook the part played by the 100,000 Croatian troops advancing into Serb-held territory.

The NATO Self-Defense Force commitment in Bosnia raises questions about the decision to cut army forces in Europe to less than a full corps with all its supporting elements. Keeping a significant force in Bosnia requires a rotation base in the United States at least twice as large. Both personnel and support units in Germany are still engaged in the Bosnian mission, degrading their readiness for other missions. U.S. ground and air forces in NATO also provide an important training partnership for European forces. NATO exercises maintain and steadily improve the standard procedures for combat operations, communications, logistics, and other technical areas essential for coalition warfare. The Gulf War could not have been fought so quickly or effectively as a coalition operation without decades of such

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multinational standardization in NATO. Future "out-of-area" NATO missions will become increasingly difficult unless the United States maintains a full army corps and supporting air force wings in Europe.

Most of the military missions that the United States now faces and has confronted for the past four or five years, as well as the ongoing ones in Europe, Japan, and Korea, depend primarily on ground forces backed up by airlift, sealift, tactical air power, logistics, communications, and intelligence. Haiti, Bosnia, NATO expansion, stability in Korea, keeping Iraq in check—these are primarily army and air force missions. Yet the army has been reduced by about 40 percent, while the navy has been cut back far less and the marines hardly at all.

The threats that carrier battle groups and a large attack submarine fleet were built to confront no longer exist. With the demise of the Soviet navy, there is no significant naval fleet in the world other than the U.S. fleet. Nor could one emerge quickly. It would require a country like Japan, with its advanced industrial base, several decades to build a naval threat. The Russian navy will not regain more than a modest portion of its predecessor's potential any time soon.

THE RIGHT TECHNOLOGY FIX

PERRY ENDS with advice on how to exploit technology, specifically for air dominance, precision strike forces, and battlespace awareness. While there are surely worthwhile gains to be realized in these three areas, what Perry does not say about exploiting technology is far more important. Carriers and amphibious forces are based on mid-twentieth-century technologies, heavily "product-improved" over the last four decades without overcoming their inherent limitations. In other words, more and more technology has been poured into these increasingly obsolete forces. Another $19 billion is to be spent on carriers and their air wings over the next ten years—roughly the cost of two army heavy divisions. The navy should be cutting its fleet and operating budget so that it can invest in research and development for a new fleet appropriate to the demands and technologies of the 21st century. The absence of a significant naval threat gives it the opportunity to maintain a very small fleet for a decade or so. Instead, the navy stubbornly insists on entering the next century with a large fleet laden with

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expensive new technology of dubious value. It wants to put stealth fighters on carriers and it seeks to put theater missile defense systems at sea as a way to justify largely superfluous Aegis cruisers. The submarine fleet continues to receive new vessels when it is too large for any conceivable challenge it could face in the next several decades.

Ballistic missile defense is the most important new technology for the U.S. military.

Perry and the air force deserve credit for deciding to cut the B-2 procurement. Unfortunately, forces in Congress reversed their decision, insisting on a far larger strategic bomber fleet than is necessary. The air force now has 84 B-1s, and its B-2 fleet is growing from 14 to 20. Strategic bombing in the Gulf War proved far less effective than the initial advertising suggested. The overwhelming majority—70-80 percent—of Iraqi tanks were destroyed by army tanks and attack helicopters, not by strategic or tactical aircraft. The new money allocated for B-2s could be better spent expanding the air transport fleet of C-17s.

Perry is absolutely right in saying that the United States needs to maintain "air dominance," but it is also important to remember that the U.S. Air Force demonstrated that capability so overwhelmingly in the Gulf War that most countries see the futility of investing heavily in air forces if they intend to fly against the United States. No other air force can hope to stand up to it, so why buy an expensive air force and lose it in the first day of combat? The rational alternative is to invest in ballistic missiles if one wants to attack the rear areas of U.S. forces. Not surprisingly, there is a growing market demand for ballistic missiles in several parts of the world. In his February 1995 annual report to Congress, Perry noted that 15 countries have ballistic missiles, and 25 possess or are developing weapons of mass destruction. If new technology is important in any area for the U.S. military, it is in ballistic missile defenses.

In all three technology areas—air dominance, precision strike, and battlespace awareness—U.S. capabilities have long been superior. These technology areas, seen in the Gulf War as new and cutting edge, are relatively old, dating to the 1960s and 1970s. Much research and development spending has resulted in little improvement in capabilities except in communications. The greatest gains from precision

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strike investments demonstrated in the Gulf War were in the accuracy of M-1 tank guns and Apache attack helicopter weaponry. They killed the majority of the Iraqi ground forces, mostly with first-round hits. When compared with the cost of destroying ground forces with air force precision munitions and traditional bombs, the advantage tilts heavily in favor of M-1 tanks and Apache helicopters. The day of close air support against sophisticated opponents may have passed, but air force capabilities retain their value for the destruction of fixed targets, especially those deep inside enemy territory.

The major limits on exploiting long-available technologies are not inadequate research and development and procurement, but rigid and parochial organizational systems within and among the military services. This remains true in intelligence, logistics, joint operations, strategic airlift and sealift, and tactical military communications. As missions in Bosnia, Haiti, the Persian Gulf region, and elsewhere expand, the real challenge is to adapt existing high-technology forces to meet them rather than plan for a Third World conflict complete with a central front. Some central front capability must be maintained, but the greater challenge is to maximize the advantages of a high-tech M-1 tank, a Bradley Fighting Vehicle, and jet engine capabilities.

None of this is to naysay the importance of keeping up a strong research and development program. Rather, it is to say that the Pentagon's research and development strategy is aimed at defending the status quo force structure, and that technology that has long been available has yet to be fully exploited. Focus and common sense are needed to avoid squandering research and development funds on bureaucratically inspired programs like the Marine Corps' proposed amphibious assault vehicle or its V-22 Osprey helicopter. Navy and air force schemes for limited missile defense fall into the same category. So does the Sea Wolf submarine program. Meanwhile, the high-tech impressions given the public during the Gulf War were based mainly on laser-guided bombs developed during the Vietnam War, AWACS radar planes developed in the 1970s, and stealth aircraft that are only somewhat newer.

The truly revolutionary aspects of the Gulf War were the airlift and sealift capacities to move more tonnage to Saudi Arabia than was moved across the English Channel during the Normandy invasion. Moving nine ground divisions and supporting airpower halfway around the

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world in a few months truly marks a new threshold in demonstrated military power. Yet it could have been done in weeks had the Pentagon invested the cost of two or three carrier battle groups in airlift and sealift capabilities a decade earlier. Controlling thousands of aircraft in the air at the same time was also a revolutionary development, but the capability was not so new. The Global Positioning System for guiding ground forces was revolutionary too, but not as technology, rather as an organizational awakening in the army. Cruise missiles made their debut in combat, but they date back to the 1970s, and the question of how best to use them remains unresolved.

DE FACTO DISENGAGEMENT

WITHOUT SHARPER regional focus and setting of priorities, the defense budget debate will leave much of the public and many members of Congress with no practical basis for judging one regional contingency against another. The Pentagon's planning device, the so-called major regional contingencies, pays almost no attention to the "prevent" and "deter" missions and encourages debate only about "defeat" missions that are far less probable. A more serious problem, however, is the force structure predicament that has already emerged. The heavy emphasis on carriers and amphibious forces has been financed by reducing ground and air forces. The emerging force structure may result in the incremental withdrawal of the United States military from key alliances in Europe and northeast Asia. The withdrawal is being thinly but effectively veiled by hoopla about "power from the sea" and new technologies for "precision strike" weapons, while existing technology is only marginally exploited and much of it is used by increasingly obsolete forces.

American retreat from forward ground force presence leads inexorably to disengagement and isolation. Whether the retreat is to the sea, the sky, space, or research and development laboratories is of little consequence to the rest of the world. The emerging force structure reflects strong coalitions of industry lobbies, local political interests, and interservice rivalries. When the comfortable illusion of what the emerging force structure can actually do is stripped away, this is the reality.

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The End of the Business Cycle?

Steven Weber

WAVES TO RIPPLES

WESTERN POLITICAL economy since the Industrial Revolution has been a vibrant world of rapid growth and development, at least for countries in the industrial "core." But it has also been a world of continuing and sometimes enormous fluctuations in economic activity. Business cycles—expansions and contractions across most sectors of an economy—have come to be taken as a fact of life. But modern economies operate differently than nineteenth-century and early twentieth-century industrial economies. Changes in technology, ideology, employment, and finance, along with the globalization of production and consumption, have reduced the volatility of economic activity in the industrialized world. For both empirical and theoretical reasons, in advanced industrial economies the waves of the business cycle may be becoming more like ripples.

The dampening of the business cycle will change the global economy and undermine assumptions and arguments that political economists use to understand it. "History counsels caution," Alan Greenspan warned the Senate banking committee in February 1997, about "visions of such 'new eras' that, in the end, have proven to be a mirage." Greenspan is surely right to warn against too easily accepting that the present is fundamentally different from the past,

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STEVEN WEBER is Associate Professor of Political Science at the University of California at Berkeley and fellow at the Center for Advanced Study in the Behavioral Sciences.

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but a growing body of evidence suggests that the world may indeed be witnessing important changes in how business cycles work.

CYCLING THROUGH HISTORY

BUSINESS CYCLES have been linked to big changes in international politics and economics over the last century. The depression at the end of the nineteenth century closed a historic era of advancing free trade and saw Germany and America move decisively toward protection. A shift in world economic power laid the groundwork for conflicts that would culminate in world war. The Great Depression of the 1930s brought international protectionism and the near collapse of trade. The gold standard disintegrated after competitive devaluations, and competing monetary blocs developed. The depression tore apart international cooperation, preparing the way for the rise of illiberal nationalist ideologies—most prominently Nazism—that contributed, in turn, to another world war.

Thirty years later, the oil shock and ensuing stagflation of the 1970s forced energy importers to compete intensely for export markets, driving many to borrow heavily from states and banks. A number of developing economies suffered debt crises and slid backward in the "lost decade" of development. In the North, tight monetary policies, slow growth, and high inflation boosted protectionist forces while drawing voters away from liberals and social democrats and toward Reagan, Thatcher, and other proponents of a new conservatism. The Bretton Woods system for international monetary cooperation finally came to a de facto end in 1973 and a de jure one in 1976. Partly in response, the Group of Seven (G-7) was created in 1975 and the European Monetary System, the precursor to the European Monetary Union, in 1979.

Relations between the North and the South are also tied to business cycles. Development depends on sustained global growth that requires trade and open markets, stable investment flows, diffusion of appropriate technologies, and protection of the environment. Business cycles complicate each of these. Foreign aid comes under pressure when economic activity slows. Downturns in the North breed protectionism, closing markets for producers in the South. Interest and exchange rate shifts can make debt service more bur-

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densome and bring devaluation or default and the attendant political risks. Finance also tends to follow business cycles; investment flows that increase during upswings often suffer retrenchment and repatriation during downturns.

Perhaps it never before made sense to ask what would look different if something assumed to be a constant was no longer around. But it is not enough to assert, like *The Economist*, that since there have always been business cycles, there will always be business cycles.[1] Understanding what causes business cycles and how those causes have changed suggests that business cycles will not be as important in the future as they were in the past.

BOOM TO BUST

A TYPICAL business cycle has four stages: prosperity, transition, depression or recession, and recovery. The story is familiar. During prosperity, banks lend, consumers and firms spend, and new jobs push the work force toward full employment. But eventually growth slows, interest rates rise and make some investments unprofitable, wage demands exceed gains in productivity, and inputs for production become more expensive. The costs of doing business increase across the board and firms' profit margins begin to fall. Some lay off workers, and the rate of investment declines as businesses focus on selling inventory rather than developing new ideas. The economy moves toward recession or depression as demand slackens: consumers postpone spending while firms reduce investment and try to streamline production by laying off more workers. The general mood becomes increasingly pessimistic as employment, income, and demand all decline. But eventually prices adjust to the decline in demand and wages and interest rates fall, usually as a result of both government action and a drop in the number of people and firms seeking loans. Investment starts to pick up as inventories run down and returns on new projects exceed the costs of borrowing. Businesses start to buy more and hire more labor. New jobs spur consumer

[1] "Taking the Business Cycle's Pulse," *The Economist*, October 28, 1995, pp. 89-90: "Economies have moved in cycles from boom to slump for centuries. There will certainly be another recession some day. The only question is when."

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optimism, hence spending. The surge in demand brings the economy back to the prosperity phase, and the cycle begins again.

No one is precisely sure why business cycles occur. Modern business-cycle theory is essentially a series of stories about cyclical responses to external shocks. The real questions are where shocks come from and what turns a shock into a business cycle. There is more disagreement about answers to the first question than to the second.

Two lines of argument see shocks coming principally from the demand side. The first emphasizes "errors" in monetary policy that cause instability in real expectations. If the U.S. Federal Reserve, for example, were to lower or raise interest rates at an inappropriate moment, consumers might well respond by spending more or less, thus affecting changes in prices. Businesses could mistake that move in prices for an actual change in underlying demand, and consequently make poor investment decisions. Suddenly supply and demand are badly out of sync, and a business cycle has begun.

John Maynard Keynes pointed to a second scenario. He claimed that private decisions to consume depend on an individual's psychology and the relationship between his or her income and spending. Businesses, meanwhile, invest by making assumptions about the marginal efficiency of capital. All of these assumptions and decisions have to be made in the context of mixed and confusing data as well as volatile and uncertain expectations—about demand, technology, productivity, future prices, and so on. Those expectations are erratic. "Irrational exuberance" can cause too much spending, while pessimism can do the opposite.

Shocks, however, can also come from the supply side. An embargo, a war, or even a fluctuation in weather could dramatically change the price of important inputs. Productivity shocks, usually brought on by a sudden change in technology that alters the costs of production or results in an entirely new product, can also upset the basic contours of supply. New technologies require decisions about new capital goods, but these take time. In the interim, innovations cause price fluctuations that set off business cycles.

Uncertainty in business planning leads to mistakes that spread throughout the economy. This uncertainty is made worse by the competitive structure of the economy and the time lag between perceived

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demand and production. Complex psychological factors come into play as business planners look not only to the external world with its confused signals about prices and demand, but also to each other for signals of optimism and pessimism. Business investment fluctuates while inventories expand and contract in ways that do not closely reflect changes in demand. Prices may shift relatively easily to adjust to new market conditions, but wages, which are sticky, generally shift less, causing unemployment. All these factors multiply and accelerate throughout the economy. Profits fluctuate, and so do future expectations of profits. Investment calculations change. And so on and so forth.

STRANGE DAYS?

As the American economy enters its seventh year of sustained growth with minimal inflation and historically low unemployment, pundits commonly describe the most recent business cycle as "different," "peculiar," or "strange." In fact, it may not be an aberration, but the next step in a new trend.

Economist Victor Zarnowitz has shown that since World War II, the expansion phases of U.S. business cycles have gotten longer on average but also more variable in length. Meanwhile, contractions have gotten shorter and more uniform in length, as well as milder overall. In that context, the recent American experience does not look so strange. The U.S. economy has been in a sustained expansion phase more or less since the fall of 1982, interrupted only by a shallow and brief recession in 1990-91 that barely deserved the name. Real output declined a total of only 1.6 percent and only for two quarters. Unemployment reached a little above 7 percent. Expansion returned as early as March 1991, and has shown no real sign of letting up.

The expansion of the 1990s has been notable for the lack of inflationary pressures. Two forces that usually drive inflation—low unemployment and high capacity utilization, or the efficiency with which businesses use their machinery—do not seem to be operating "normally." The assumption has been that once unemployment falls below some particular threshold, labor is in such demand that workers can insist on higher pay. This is the classic story of wage-

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driven inflation, but in recent years such inflation has been nearly absent. The Federal Reserve reportedly uses 6.2 percent as a conservative estimate of the minimum rate of unemployment consistent with low, steady inflation. Unemployment drifted downward from 6.4 percent in December 1993 to 5.4 percent in December 1994, and has since steadied between about 5.6 percent and 5.2 percent, with an overall average of 5.4 percent for 1996. Yet there is no evidence of substantial inflationary pressure resulting from demands for higher wages. Between 1993 and 1996, average weekly earnings in nonagricultural private industries rose annually by only 2.8 percent, 3.3 percent, 2.3 percent, and 3.0 percent. In real terms, U.S. wages have either fallen or only negligibly increased for at least 15 years.

Business cycles are becoming less prevalent, less severe, and less significant.

Capacity utilization is also supposed to drive inflation when it reaches 81-82 percent. But utilization hit 81 percent in mid-1992 and has remained above 82 percent (mostly above 83 percent) since 1994. In the winter of 1995 it peaked at over 85 percent. The mild slowdown of spring 1995 brought the level down only to 83.7 percent, still significantly above the supposed threshold for inflationary pressures. Yet producer and consumer price inflation remain subdued—around 2.7 percent and 3 percent, respectively, in 1996. And recent studies suggest the consumer price index may overstate the problem by as much as half. At the same time, expectations about future inflation, as reflected in 30-year Treasury bond yields, have steadied; average yields have declined from over 8 percent in 1991 to around 6.71 percent in 1996.

These peculiarities have prompted occasional speculation that the business cycle has somehow died, as well as declarations that nothing fundamental has changed. A more modest and defensible argument is that the current cycle reveals important changes in the operation of modern economies, and that these changes will tend to dampen business cycles and render them less prevalent, less severe, and less significant than in the past. The significance of exogenous shocks is diminishing, and the cyclical dynamics that respond to shocks are increasingly restrained.

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THE NEW ECONOMICS

SIX FACETS of the modern economy contribute to the dampening of the business cycle: the globalization of production, changes in finance, the nature of employment, government policy, emerging markets, and information technology. These six factors tend to reduce transaction costs, make supply and demand more fluid, compensate for production imbalances, and smooth out growth and adjustment. There will certainly still be economic shocks, whether from natural or political events or technological change. And just as surely there will be errors in monetary policy and mistakes in business planning. Those fundamental forces of the business cycle have not gone away. They will, however, be less important in a more flexible and adaptive economy that adjusts to shocks more easily and with less propensity for sparking a new cycle.

The shifts in employment—from manufacturing to service jobs and from career employment to temporary employment, often with several employers—contributes to the dampening phenomenon. In 1950 services employed about half of U.S. workers. By the mid-1990s services accounted for almost 80 percent of American jobs. The U.S. numbers are the most dramatic, but they are not out of line with trends in other advanced countries. This is important because service employment is generally less cyclical than employment in manufacturing. Most services are less vulnerable to large swings in inventories, simply because of the difficulty of building up or running down stocks of intangible goods or altering the rate at which services can be provided. Indeed, the demand for many services remains relatively constant through downturns in economic activity. Restaurants and doctors suffer during recessions, but not nearly as much as makers of automobiles. Government services tend to be countercyclical, in greatest demand when times are tough. In the most recent American economic downturn, around 1991, manufacturing output dropped about 3.4 percent, while the output of services did not decline at all. Even in the manufacturing "powerhouses" the difference was clear: Japanese manufacturing output dropped 13.5 percent in the last downturn, while services dropped only 2 percent; for Germany the numbers were 11 percent and 0.2 percent, respectively.

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The increase in services employment is also a factor in the general decline in union strength, since unions are typically stronger in manufacturing and industry. In 1953 more than a third of American workers belonged to unions. Today only one in ten private-sector workers are unionized. Finland and Sweden aside, union membership fell in all Organization for Economic Cooperation and Development countries during the 1980s, on average more than 6 percent each year. Weaker unions herald reduced bargaining power for workers and diminished pressure for wage-driven inflation. One measure of that trend, albeit imperfect, is the declining tendency to strike in almost all advanced industrial countries. In 1995 strikes fell to a 50-year low in the United States, and in 1996 only nine strikes involved more than 5,000 workers. Declining union power contributes to the development of increasingly flexible labor markets, extending to downwardly flexible real wages in some OECD countries, notably the United States.

Labor market flexibility also gains from the shift from the old paradigm of lifetime employment to a new one of temporary work, which is expanding briskly. While the Fortune 500 companies reduced their full-time labor force by more than 30 percent over the last 15 years, the number of temps in the United States has grown nearly 19 percent in the last 3 years and now accounts for 10 percent of the American work force. Growth has been most rapid in technical and professional fields (including not-so-low-wage fields like accounting, computer services, and medicine), where, paradoxically, permanent status as a temporary worker is becoming an increasingly respectable career path. The overall effect should be a more efficient labor market where redeploying labor, an expensive factor in the production process, is cheaper and easier. While such changes are certainly neither cheaper nor easier for workers, improvements in continuing education and progress on portable health insurance arrangements could change the parameters.

Rapid innovations in information technology may also work to dampen the business cycle. At an abstract level, information technology reduces the price and raises the quality of the information businesses use to make decisions. This process is making an important practical difference in the management of inventories whose mismanagement contributes to cycling. In the United States and Britain, the ratio of stocks to sales in manufacturing fell about 17 percent during the 1980s,

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and U.S. ratios fell an additional 8 percent in the first half of the 1990s. In 1994 inventory expansion added just 0.6 percent to GDP growth. Two years later, changes in inventories accounted for only 0.2 percent of change in real GDP.

Trimming down inventories works in part because more firms are using sophisticated information technology systems for supply chain management. Decisions about how much to produce, what inputs are needed when and where, and whether it is possible to track down alternative sources for an input in short supply are increasingly made with the assistance of sophisticated computer software that tracks hundreds of variables and adjusts production schedules to optimal configurations. Apart from smoothing out fluctuations driven by purchasing for (and selling from) inventory, information technology almost certainly contributes to overall efficiency by shortening the time to market. The computer manufacturer Dell, for example, has just built a factory with no space for inventory at all. In some industries the term "supply chain" is itself becoming obsolete as information systems running in both directions link suppliers directly to factories on one side and customers on the other.

The increasing ease with which the production, distribution, and maintenance of goods and services locate around the world will stabilize business cycles, primarily by reducing the sensitivity of economic activity to conditions in any single country. Claims of a borderless global economy are still a vast exaggeration. But for an increasing number of firms—and not just the biggest multinationals—demand and supply are becoming more global than national. As trade barriers and transportation costs continue their long postwar decline, both capacity and demand—still measured primarily in national accounts—move with increasing ease across political boundaries.

The shift toward services reinforces this trend. Just as services are becoming more important in most businesses, trade in services is increasing, in recent years at a rate far exceeding trade in manufactures. So-called invisible exports, which include services, noncommercial transfers of capital, and income from overseas assets, reached $2.4 trillion worldwide in 1993; global merchandise trade that year was $3.6 trillion. For the United States, which leads the world in invisible exports and accumulates the world's largest invisible trade surplus,

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these exports may now account for upwards of 10 percent of GDP. The growth and development of financial markets, further (even patchy) progress in the World Trade Organization (WTO) on services, privatization in telecommunications and energy, and other advances will likely accelerate these trends.

MORE MARKETS, MORE MONEY

DURING THE 1980s finance went high-tech and global. Stock markets, the mainstay, are expanding around the world. Many Latin American countries began the 1980s with stock market capitalizations—the worth of all stocks trading on the market—of around 5 percent to 10 percent of GNP. Now the numbers range between 50 percent and 100 percent, and at least five developing countries have stock market capitalizations greater than national income. Along with larger capitalizations and greater liquidity comes increasing efficiency at linking capital to production and managing risk. Developed countries' market capitalization rates have increased as well, if somewhat less in relative terms, simply because they had larger markets to begin with. Worldwide market capitalization tripled in the decade beginning in 1986.

The growth of other financial markets as well as mutual funds and similar products has been phenomenal—particularly, but not only, in the United States. Concerns about derivatives trading reflect that enormous growth. In developed countries, trading in over-the-counter derivatives exceeded $8.5 trillion in 1993, along with more than $6 trillion in interest rate swaps outstanding. Activity in standard financial instruments traded on exchanges (currency futures, stock market index options, interest-rate futures) doubled between 1992 and 1994. These new financial products spread and diversify risk. And despite a few heavily publicized losses on derivatives contracts in the mid-1990s, these numbers will probably climb higher as corporate treasurers and fund managers become better at using these new tools to stabilize financial flows and protect themselves against shocks.

Money is also increasingly raised and borrowed internationally, with greater diversity in funding sources. The OECD reports that total borrowing on international capital markets rose to more than $830 billion

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in 1995, from less than $360 billion just five years before. In 1995 U.S. investors bought almost $940 billion in foreign bonds and $396 billion in foreign stocks. In 1989, the peak year of Japan's boom, that country bought $94 billion worth of foreign bonds and $18 billion worth of foreign equities. Foreign exchange trading has grown most quickly, in part to support trade but also simply as a self-contained market. No one knows exactly how large that market is, but daily turnover exceeded $1 trillion per day sometime back in 1993.

Global capital markets are increasingly efficient at linking capital to production, managing risk, and providing shock absorbers that cushion economic fluctuations. And the wider array of funding sources and more sophisticated risk management techniques are stabilizers for a globalizing economy. A firm that wants to borrow money can now inexpensively choose the currency and terms of a loan. Investors can buy repackaged pieces of risk and spread their holdings across countries, industries, and time periods. While the complexity seems daunting and may lead to greater volatility for some individuals or firms, overall the global economy should benefit as short-term ups and downs in any single market or small group of markets can be compensated for elsewhere. The doomsday argument, advanced by writers like William Grieder, that complex markets might act in synergy and come crashing down together is simply not supported by a compelling theoretical logic or empirical evidence. Two and a half years after the peso collapsed in Mexico, the striking aspect of that "crisis" is how limited the feared "Tequila effect" turned out to be in both scope and longevity.

Complex markets will not act in synergy to come crashing down together.

The explosive growth of emerging markets in the post–Cold War world should also dampen the business cycle. Unlike the Asian Tigers of a decade ago, the new emerging economies include large populations and rapid growth rates. Brazil doubled its inflation-adjusted per capita income between 1961 and 1979; China did the same between 1977 and 1987. International Monetary Fund estimates for growth rates in the developing world are now more than double those for the developed world. Explosive growth in even a few of these very large economies will change the way the world economy works.

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The most direct impact is the effect that a billion-odd new consumers could have on demand. A few conservative estimates give a feel for the stakes. The World Bank believes that in 2002 a "Chinese Economic Area" comprising China, Hong Kong, and Taiwan could have GDP of $9.8 trillion, a little larger than America's projected GDP at that point. An embryonic middle class is already fueling a consumption boom. From pagers to refrigerators to automobiles, demand growth in the developing world is set to outpace that in the West. On top of that growth, there will be an unparalleled demand for new infrastructure and public investment. Asian nations alone will spend several trillion dollars in the next decade to build electrical power grids, roads, telephone systems, and airports in staggering numbers.

The developed world will meet a substantial part of this demand. American exports to developing countries make up more than 40 percent of total U.S. exports, while in Japan the figure is nearly 50 percent, and such exports are growing much faster than those to other developed countries. The 1990-91 downturn highlighted the significance of this trade. Developing countries' demand for imports barely slowed. In fact, continuing growth in the developing world, which stayed above 5 percent, was a dynamo that helped keep the recession in the North both mild and short.

Emerging economies will drive supply-side effects as well. In the short term, the fear of losing out to lower-wage producers in the developing world will slow demand for higher wages among workers in the North and thus inhibit wage-driven inflation. But in the longer term, emerging economies will drive developed countries to make investments in human and physical capital and to move upmarket technologically, all of which spurs productivity. Meanwhile, terms of trade will improve as the cost of rich countries' manufactured imports declines. A hard turn toward protection against developing country imports obviously would hamper this virtuous cycle. But the political forces that support general protectionism are not strong in most Western states. In the United States protectionists lose the big wars—over the North American Free Trade Agreement (NAFTA), over most-favored-nation status for China, over the WTO—even if they win the occasional battle. And pressure for broad protection will weaken as exporters and others who gain from open trade advance their

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agenda. Add explosive growth in portfolio and foreign direct investment in the developing world, particularly after 1993, and the result is a strong constituency of interest groups from developed countries that benefit from growth in what used to be called the Third World.

THE SOUTH GOES NORTH

AN INTERNATIONAL political economy with subdued business cycles in the industrial core will operate differently from the postwar political economy, with important consequences for North-South relations, government policy, the role of international institutions, and the future of employment.

The central issue of political economy in North-South relations is whether the liberalization of developing economies, a crucial component of rapid growth in the South, will continue. Sustained global growth, open markets for trade, stable and substantial capital flows, technology diffusion, and progress on management of environmental problems are necessary conditions for continued development. The dampening of the business cycle in the core should help at least some: moderate, stable growth provides a more auspicious environment for adjustment than boom and bust. The North must redeploy capital and human resources, steps that require training, education, research and development, and investment. Steady growth with low inflation should facilitate those measures and encourage longer-term planning by businesses, individuals, and governments. Deep downturns, on the other hand, transfer votes and power to protectionists. If there are no deep downturns, protectionist forces can be more easily kept at bay, bought off, redirected, and conciliated—just imagine how much more difficult it would have been to gain passage of NAFTA during a recession. The progressive if gradual opening of markets and a more constant flow of ideas, technology, and capital between North and South both become possible with steady growth.

Along with protectionism, immigration remains a politically significant problem in the North. Immigrants are often unwelcome in stagnant economies but are likely to be accepted—even coveted—during periods of growth. Subdued business cycles could dramatically change the political dynamics surrounding immigration. Developing

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countries already contain about 80 percent of the world's population, and almost all net growth in the global labor force over the next 30 years will take place in the South. Capital and labor seek each other out, which implies either migration of workers from South to North or capital flows from North to South. Many of the barriers to capital flows have come down. As capital markets continue to deepen in the South, bank lending, foreign direct investment, and portfolio investment from the North will all continue to grow. The dampening of business cycles should flatten out some of the boom-bust character of capital flows and promote a more regular and predictable transfer of investment to the South. The stark truth is that most political forces North and South prefer capital flows to immigration, so this solution is likely to grow, rendering immigration less of a problem.

Dampened business cycles will promote more regular investment in the South.

Debtor countries in the South today borrow money through contracts with built-in inflationary expectations, paying a premium that foreign banks reap as a windfall profit. In the future, with inflation lower than those contracts predict, growing out of debt will become harder, and at least some developing countries will have to either default on or renegotiate their debt contracts. Does this signal another international debt crisis? Possibly, but because foreign direct investment and portfolio investment have largely replaced bank lending to developing countries, and because private investors and mutual funds can absorb losses better than banks, debt rescheduling need not spawn a systemic crisis as it did in the early 1980s. Eventually low inflation will itself repair some of the damage that it inflicts in the short term; since inflation premiums in lending will decline, developing countries will be able to secure new loans at more reasonable rates. Overall, steady and low inflation rates should improve the efficiency of capital allocation around the world by removing confusion and misinformation from lending calculations. All this is quite salutary, given the growing demands for capital in the developing world.

Low inflation will also affect employment in the developed world. Lost jobs are a major political issue in the West, even if economists disagree about precisely what combination of low-wage imports and technological change leads to the elimination of jobs. How will

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developed countries respond? There will certainly be some protection, but countries that capitalize on this new global division of labor by innovating and investing in human capital to boost productivity will do best. Still, some permanent loss of certain types of jobs and an increase in structural unemployment seem likely in the developed world. This could have significant political repercussions if it means a permanent underclass of long-term unemployed, particularly if the economic divide coincides with racial or ethnic lines of fracture. For societies that view themselves as modern democracies with equal opportunity, the implications are troubling.

Some states might find currency devaluation to be politically alluring in a low-inflation world. In the short run, devaluation strategies promise to save jobs by boosting export competitiveness and raising the price of imports. But since many states are similarly tempted, the stage is set for a competitive race to devalue. New problems of cooperation would thus arise as Northern states struggled to deal with the employment consequences of flourishing production in the developing world. The G-7 states will certainly want to avoid a vicious circle of devaluation that would end with higher inflation but no gains in competitiveness. Within the European Union, incentives to avoid competitive devaluation are particularly compelling, since workers in Europe are in a relatively strong position to resist the cuts in real wages that devaluation would entail. Competitive devaluation within the EU would prove futile relatively quickly, and the accompanying political tensions might risk undoing the achievements of the single market. Indeed, those risks are part of what prompted the EU to move toward a single currency sooner rather than later.

But Europe is not the only place where exchange rate policies will be subject to additional constraints. The conventional wisdom, which sees floating exchange rates as the nearly certain future of international monetary matters, could be wrong. There are strong countervailing forces that will push in the other direction, toward a new currency scheme. The incentives states have to fix rates—primarily, reducing transaction costs for international trade and finance—become more important as interdependence increases. Export-oriented producers of tradable goods gain from fixed rates, as do overseas investors. Fixed rates also avoid the temptations of competitive devaluation.

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But the argument turns on the strength of the disincentives—the reasons why states shun fixed rates. As the EU learned during its 1992-93 currency crises, states cannot have capital mobility, fixed exchange rates, and autonomous monetary policy all at once. The standard view is that since capital mobility is here to stay, states choose autonomous monetary policy at the cost of exchange rate stability. But that choice may not be so clear in a world with dampened business cycles, where states will have less need for monetary policy autonomy under normal circumstances. Surely there will be unexpected shocks that call for changes in monetary policy. But could such adjustments be successfully coordinated within a fixed-rate system? Possibly: one country's need to change rates would be easier for others to see, evaluate, and understand, thereby facilitating cooperation. The current consensus on inflation among central bankers may already reflect this trend.

Interdependence will also constrain states' fiscal policies. Markets have priced government debt under conditions of great uncertainty about the real fiscal position of states. One reason is that government deficits are broken down analytically into a structural component and a cyclical component. The cyclical component supposedly reflects changes in spending that governments pursue in response to the business cycle, including both automatic stabilizers like unemployment insurance and changes in tax receipts, and discretionary spending like public works programs that stimulate flagging demand. The structural component of the deficit represents "built-in" overspending that would exist even after cyclical components were removed, simply because governments tend to spend more than they take in. In practice, determining a state's real fiscal position is an imprecise science; calculating the cyclical component of a deficit is difficult to begin with, and differences between countries' accounting procedures and the characteristics of their automatic stabilizers and other budgetary tools compound the problem.

But the inherently cyclical nature of government spending will decline as business cycles dampen. As automatic stabilizers diminish in importance, governments may actually gain latitude to spend money in more directly targeted ways. Futhermore, government agencies should find it easier to project revenues and expenditures. This facilitates longer-range budgeting, but it also denies governments the ability to hide behind excuses about cyclical deficits that

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will supposedly correct themselves when the recession ends. Politicians will find it increasingly difficult to defend budget proposals that incorporate widely divergent assumptions about growth rates, inflation, and tax revenues. The new transparency will yield increased pressure to reduce deficits. That pressure will likely be greatest in developed countries with particularly high debt-to-GDP ratios, including Sweden, Italy, and Belgium. In this context, the EU's convergance criteria on budget deficits and debt seem to reflect deeper causes that drive the need for tighter fiscal policies.

ROSE-COLORED GLASSES?

WHAT COULD go wrong in this scenario? At least three things, the most immediate of which is short-term unemployment in the developed world. Pressures for trade protection and immigration restrictions will almost certainly get worse before they get better. Neither declining real wages for the working class nor extensive long-term unemployment is politically sustainable in modern democratic societies. The upside is that much of what needs to be done—at least in terms of increasing incentives for investment, retooling, and retraining—is within reach of government policy. In the wake of failed health care reform, the Clinton administration's emphasis on economic security could lead to policy initiatives on education, job training, and other measures that contribute to productivity. There was, unfortunately, no single post–Cold War conference to dramatize the international importance of this challenge, but there has been a series of smaller successes, from the Maastricht Treaty to the conclusion of the Uruguay Round of world trade talks to the G-7 jobs summit in Detroit. Leadership in key countries like America, Germany, and France will be essential to effective management of this issue.

Whether structural or political, obstacles to expanding production will certainly arise in both the developed and the developing worlds; the question is whether they will be severe enough to derail continued growth. The expansion of capital markets has rendered capital insufficiency much less of a concern than just a few years ago. Energy shortages are surely possible, and a severe and lasting oil shock would be a serious problem. But oil shocks seem increasingly unlikely, given

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both the state of the market and the slowly improving political situation in the Middle East. A gradual, moderate rise in energy costs reflecting increased demand would be manageable and arguably even good for a number of reasons, including the environment. Indeed, the environment seems the most likely obstacle to expansion, and thus to future growth. Although no sign of large-scale environmental disaster looms, the possibility cannot be dismissed.

Finally, security problems have the potential to wreak havoc with any scenario. The next decade will witness sharp changes in the location and concentration of economic power around the world. As in previous eras, race, religion, and ideology are overlaid on shifting wealth. Cooperation among the G-7 on a range of issues, more likely in a world with diminished business cycles, is important, but will it be decisive enough to manage the larger challenges? Relations with China and Russia and other unresolved situations lurk in the background and will likely provide a dose of nervous uncertainty. As still-developing countries, however, their prospects for stabilization should improve just as they will for other developing countries—indeed, for all countries—that benefit from a world with dampened business cycles.

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The Dollar and the Euro

C. Fred Bergsten

THE NEW GLOBAL CURRENCY

THE CREATION of a single European currency will be the most important development in the international monetary system since the adoption of flexible exchange rates in the early 1970s. The dollar will have its first real competitor since it surpassed the pound sterling as the world's dominant currency during the interwar period. As much as $1 trillion of international investment may shift from dollars to euros. Volatility between the world's key currencies will increase substantially, requiring new forms of international cooperation if severe costs for the global economy are to be avoided.

The political impact of the euro will be at least as great. A bipolar currency regime dominated by Europe and the United States, with Japan as a junior partner, will replace the dollar-centered system that has prevailed for most of this century. A quantum leap in transatlantic cooperation will be required to handle both the transition to the new regime and its long-term effects.

The global economic roles of the European Union and the United States are nearly identical. The EU accounts for about 31 percent of world output and 20 percent of world trade. The United States provides about 27 percent of global production and 18 percent of world trade. The dollar's 40 to 60 percent share of world finance far exceeds the economic weight of the United States. This total also exceeds the share of 10 to 40 percent for the European national currencies

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C. FRED BERGSTEN is Director of the Institute for International Economics. He was Assistant Secretary of the Treasury for International Affairs from 1977 to 1981 and Assistant to the National Security Council for International Economic Affairs from 1969 to 1971. Copyright 1997 © by C. Fred Bergsten.

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combined. The dollar's market share is three to five times that of the deutsche mark, the only European currency now used globally.

Inertia is a powerful force in international finance. For half a century, the pound sterling retained a global role far in excess of Britain's economic strength. The dollar will probably remain the leading currency indefinitely. But the creation of the euro will narrow, and perhaps eventually close, the present monetary gap between the United States and Europe. The dollar and the euro are each likely to wind up with about 40 percent of world finance, with about 20 percent remaining for the yen, the Swiss franc, and minor currencies.

Even an initial Economic and Monetary Union (EMU) comprising only the half-dozen assured core countries would constitute an economy about two-thirds the size of the United States' and almost equal to Japan's. The global trade of this group would exceed that of the United States. If the gap between the current market share of the dollar and that of the European currencies were closed only halfway, that would produce an enormous shift in global financial holdings.

Substantial implications emerge for the functioning and management of the world economy. There will probably be a portfolio diversification of $500 billion to $1 trillion into euros. Most of this shift will come out of the dollar. This in turn will have a significant impact on exchange rates during a long transition period. The euro will move higher than will be comfortable for many Europeans. Europe will probably try to defend itself against this prospect by engineering a further substantial weakening of its national currencies between now and the euro's start-up.

In the long run, the dollar-euro exchange rate is likely to fluctuate considerably more than have the rates between the dollar and individual European currencies. This fluctuation could cause prolonged misalignments that would not only have adverse effects in both Europe and the United States but also provoke protectionist pressures on the global trading system. Creation of the euro will raise many policy issues that will require intensive cooperation, both across the Atlantic and in multilateral settings such as the Group of Seven (G-7) and the International Monetary Fund.

Europe has always accounted for a share of world trade comparable to that of the United States. In addition, Europe has had a common

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trade policy from the outset of its integration process. Trade policy thus has been bipolar for almost four decades, as evidenced by the necessity of Europe and the United States agreeing on all multilateral trade rounds in the General Agreement on Tariffs and Trade and recent sectoral agreements in the World Trade Organization.

The prospective developments on the monetary side would mirror that evolution, equating Europe's market position and institutional arrangements with those of the United States to produce a similarly bipolar regime. The United States, Europe, and global financial institutions are not prepared for these events. The initial blueprints for EMU ignored the issue, and there has been little subsequent discussion in Europe. The United States and the G-7 have failed to address the rise of the euro seriously, as they failed to address EMU's predecessor, the European Monetary System, even when it spawned currency crises with global effects in 1992-93. It is essential that the United States, Europe, and international financial institutions begin to prepare for the euro's global impact.

THE EURO START-UP

THERE IS considerable debate in Europe on when, with whom, and even whether the euro will be created. This analysis assumes that the euro will be introduced on or near the scheduled date of January 1999 and that its membership will quickly, if not immediately, encompass virtually the entire membership of the European Union. The euro's systemic evolution will not be affected by whether the currency is launched in 1999 or 2001, or whether the "Club Med" countries—Italy, Portugal, and Spain—are included at the start or join a couple of years later. The same conclusions apply.

The euro will probably be strong from its inception. The Maastricht Treaty gives the European Central Bank (ECB) a mandate to ensure price stability. The bank will place overwhelming emphasis on establishing its credibility as soon as possible. The ECB will be especially chary of any depreciation of the euro's exchange rate, and is likely to view euro appreciation as an early sign of success. The ECB will be the first central bank in history without a government looking over its shoulder. Since it lacks the 50-year credibility of the

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Bundesbank, the ECB will be tougher than its forerunner in pursuing a responsible monetary policy.

Fiscal policy developments are likely to reinforce this outcome. The fiscal criteria of the Maastricht Treaty will probably be interpreted flexibly to enable EMU to start on time and perhaps, largely for political reasons, to include the Club Med countries. The "growth and stability pact" to govern budget positions after start-up seems likely to have large loopholes. If unemployment remains high at start-up, the national governments will probably deploy their only remaining macroeconomic tool—fiscal policy—in an expansionary direction. That would intensify the pressure on the ECB to pursue a tight monetary policy.

Many Europeans believe that fudging the Maastricht criteria would produce a weak euro. On the contrary, combining such budgetary tolerance with a resolute ECB will further strengthen the new currency. The proper analogy is with the Federal Reserve, which produced a sky-high dollar in the early 1980s in the face of Reagan's huge budget deficits, or the Bundesbank, which produced a strong deutsche mark in the face of large deficits in the early 1990s triggered by German reunification. The ECB is likely to out-Fed and out-Bundesbank its most distinguished role models.

The advent of the euro's global role must be considered across three time periods: the run-up from now until 1999, a transition period of five to ten years during which the euro will attain its new position in international finance, and in the long term, when relatively stable structural conditions will have been established.

GLOBAL MONEY

FIVE KEY factors determine whether a currency will play a global role: the size of its underlying economy and global trade; the economy's independence from external constraints; avoidance of exchange controls; the breadth, depth, and liquidity of the economy's capital markets; and the economy's strength, stability, and external position.

On the first two criteria, a unified Europe is superior to the United States. The European Union's GDP was $8.4 trillion in 1996, compared with $7.2 trillion for the United States. Growth of potential output is

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similar in the two regions, so their relative position should hold. The European Union also has a larger volume of global trade. EU external trade totaled $1.9 trillion in 1996, compared with $1.7 trillion for the United States.

In terms of openness, the share of exports and imports in total output is now about 23 percent in both the EU and the United States. This ratio has doubled for the United States over the past 25 years while rising only modestly in Europe, but it is also likely to remain broadly similar. Both regions are thus largely independent of external constraints and can manage their policies without being thrown off course by any but the most severe external shocks.

It is almost inconceivable that either the EU or the United States would unilaterally resort to exchange or capital controls. Globalization of capital markets has reached the point where all major financial centers, including many in the developing world, would have to act together to alter international capital flows effectively. Hence the two regions will remain parallel on this key currency criterion as well.

It is less clear when Europe will reach full parity with the United States in terms of the breadth, depth, and liquidity of its capital markets.

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The American market for domestic securities is about twice as large as the combined European markets. The European financial markets are highly decentralized. There will be no central governmental borrower like the U.S. Treasury to provide a fulcrum for the market. It may take some time to align the relevant standards and practices across the EU, especially if London is included. Germany may oppose wholesale liberalization, as the Bundesbank has traditionally done in Germany, on the grounds that it would weaken the ability of the ECB to conduct an effective monetary policy.

America's trade position will raise doubts about the future value of the dollar.

On the other hand, the total value of government bond markets in the EU is 2.1 trillion euros, compared with 1.6 trillion euros in the United States. Moreover, international bonds and equities are much more frequently issued in the European markets than in the United States. Futures trading in German and French government bonds, taken together, exceeded that in U.S. notes and bonds in 1995. Expectations over the launch of EMU have already produced a substantial convergence in the yields of government bonds throughout Europe. An integrated European capital market for private bonds shows clear signs of developing. So European parity on this key criterion is likely to occur eventually.

The final criterion is the strength and stability of the European economy. There is no risk of hyperinflation or any of the other extreme instabilities that could disqualify the euro from international status. On the contrary, the ECB is likely to run a responsible monetary policy. On the other hand, Europe may not carry out the structural reforms needed to restore dynamic economic growth. But markets prize stability more than growth, as indicated by the continued dominance of the dollar through extended periods of sluggish American economic performance. Hence the euro should qualify on these grounds as well.

In addition, America's external economic position will continue to raise doubts about the future stability and value of the dollar. The United States has run current account deficits for the last 15 years. Its net foreign debt exceeds $1 trillion and is rising annually by 15 to 20 percent. The EU, in contrast, has a roughly balanced international asset position and has run modest surpluses in its inter-

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national accounts in recent years. On this important criterion, the EU is decidedly superior to the United States.

The relative size of countries' economies and trade flows is of central importance in determining currencies' global roles. A large economy has a naturally large base for its currency and thus enjoys important economies of scale and scope. A high volume of trade gives a country's firms considerable leverage to finance in their own currency. Large economies are less vulnerable to external shocks and thus offer a safe haven for investors. They are more likely to have the large capital markets required for major currency status.

There is a clear historical correlation between size and currency status. Sterling and the dollar became dominant during the periods when the United Kingdom and the United States were the world's main economies and traders. The only global currencies today are those of the world's three largest economies and traders: the United States, Germany, and Japan.

The relevant comparison for present purposes is between the EU and the euro, on the one hand, and Germany and the deutsche mark on the other. It would be improper to compare the euro, which will meet all of the key currency criteria, with the sum of the individual European currencies, most of which do not. The comparison must be with the deutsche mark, the only European currency that is now used on a global basis.

Hence there will be a quantum leap in the size of the economy and trading unit in question. Germany accounts for nine percent of world output and 12 percent of world trade. The euro core group accounts for 18 and 19 percent, respectively. The full EMU accounts for 31 and 20 percent, respectively. The relevant unit will thus increase immediately by at least 50 to 100 percent. Eventually, the rise will be about 65 to 250 percent.

Crude econometric efforts suggest that every rise of 1 percent in a country's share of global output and trade raises its currency share by roughly the same amount. On this premise, the global role of the euro would exceed that of the deutsche mark by 50 to 100 percent if EMU included only the core group and by 65 to 250 percent if all Europe were included. The deutsche mark, by most calculations, accounts for about 15 percent of global financial assets in both private and official markets. The euro's role could thus reach 20 to 30 percent of world

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finance if EMU included only the core countries and 25 to 50 percent if the entire EU were involved. The midpoints of these ranges, 25 and almost 40 percent, provide rough indicators of the likely future global role of the euro. If these shifts into the euro came largely out of the dollar, they would eliminate half to all of the present gap between the dollar and the deutsche mark.

Many agree that the euro will rival the dollar as the world's leading currency.

This evolution could produce a major diversification of portfolios into euros, mainly out of dollars. Official reserve shifts into euros could range between $100 billion and $300 billion. Private portfolio diversification could be much larger. Excluding intra-EU holdings, global holdings of international financial assets, including bank deposits and bonds, are about $3.5 trillion. About 50 percent are in dollars and only about 10 percent in European currencies. A complete balancing of portfolios between dollars and euros would require a shift of about $700 billion. A combination of official and private shifts suggests a potential diversification of between $500 billion and $1 trillion.

Such a shift, even spread over a number of years, could drive the euro up and the dollar down substantially. The extent of the shift will depend on whether the supply of euros rises in tandem with demand. It will also depend on the relationship between the dollar and the European national currencies when the euro is issued. While most Europeans want a strong euro, they also want to avoid an overvalued currency that deepens their economic difficulties. Many believe that their national currencies are already overvalued despite recent substantial declines against the dollar. The only way they can avoid the dilemma is to depreciate the European national currencies further before the launch of the euro. The EMU would then be able to set the initial exchange rate below the fundamental equilibrium exchange rate for the euro. The euro could appreciate modestly without undermining the long-term competitive position of the European economy.

Exchange-market developments from now until the early part of the next century could be a mirror image of the first half of the 1980s. During that period, U.S. budget deficits soared. The elimination of Japanese exchange controls triggered a large portfolio diversification

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from yen into dollars. Fiscal tightening in Europe and Japan further enhanced the dollar's appreciation. The opposite conditions may apply in the period ahead: further reductions in, or even elimination of, the American budget deficit could coincide with European fiscal expansion and a large diversification out of the dollar triggered by the euro's creation. Substantial euro appreciation and dollar depreciation could thus occur in the transition to EMU.

Many analysts agree that the euro will rival the dollar as the world's leading currency. Most believe, however, that such a shift will take considerable time, since any redistribution of international portfolios occurs incrementally. But there is evidence from the history of major currencies that major shocks can produce rapid changes in portfolio composition. The devaluation of the pound sterling in 1931 permanently reduced the international role of that currency and propelled the dollar into the dominant position. The onset of double-digit inflation in the United States in the late 1970s produced a sharp drop in the dollar's role in just a few years.

These shocks, however, have derived more from poor policy and performance by the lead currency than from the improved position of the new rival. The euro's rise may have to await a serious policy lapse by the United States, as in the late 1970s, or a renewed explosion of America's external debt position, as in the mid-1980s. Even the most successful and best-managed countries undergo occasional setbacks, and the euro's rough parity with the dollar is probably inevitable.

JAPAN AS JUNIOR PARTNER

THE YEN will continue to play an important but smaller role, maintaining its 10 to 15 percent market share. But the world is not likely to see a tri-polar monetary system. The Japanese Ministry of International Trade and Industry's latest report on the topic concludes that "the yen is nowhere near achieving the status of a truly international currency." Japan will need to be included in any new EU-U.S. arrangements but will probably remain a junior partner in the management of the international monetary regime.

Japan's economy is about twice the size of Germany's. Its trade is only slightly smaller, and it has an even better record of price stability

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over the past 15 years. Yet its currency plays a much smaller role than the deutsche mark, suggesting a significant deficiency when it comes to the other key currency criteria—notably the capabilities of its financial markets. Japan's continued failure to deregulate and modernize those markets is likely to remain a barrier for the yen. Indeed, the fragility of Japan's financial sector is more likely to repel than attract international interest.

Many analysts have hypothesized the emergence of three north-south regional blocs centered around Europe, Japan, and the United States. So far, however, major trade groupings have developed around Europe and the United States but not around Japan. With the Asia-Pacific Economic Cooperation forum linking the United States and Japan, bipolarity may be evolving not only in monetary affairs but in trade as well.

THE NEW TRANSATLANTIC AGENDA

THE EURO'S rise will convert an international monetary system that has been dominated by the dollar since World War II into a bipolar regime. Hence the structure and politics of international financial cooperation will change dramatically.

The exchange rate between the euro and the dollar will pose a significant policy challenge. The United States and the rest of the world should reject any attempt by Europe to substantially undervalue the euro's start-up rate. It would represent a blatant effort by Europe to export its high unemployment and to enable the euro to become a strong currency without any significant cost to its competitive position.

France is running sizable trade and current account surpluses, even adjusted for its high level of unemployment. Germany has the world's second-largest trade surplus and is the world's second-largest creditor country. The EU is a surplus region. By contrast, the United States is the world's largest debtor nation. Its trade and current account deficits are headed well above $200 billion in 1997. These facts hardly suggest that the European currencies are too strong or that the dollar is too weak. The G-7 should, at a minimum, actively resist further European depreciation and dollar appreciation.

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SHARE OF WORLD OUTPUT AND TRADE, 1995
(in percent)

	OUTPUT	TRADE[1]
UNITED STATES	26.7	18.3
EUROPEAN UNION	30.8	20.4
CORE EU[2]	18.4	18.9
GERMANY	8.9	12.4
JAPAN	21.0	10.3

[1] GOODS AND SERVICES, EXCLUDING INTRA-EU TRADE
[2] AUSTRIA, BENELUX, FRANCE AND GERMANY

SOURCES: UNCTAND, WORLD BANK, WTO

Portfolio diversification's impact on the exchange rate between the dollar and the euro will also pose a challenge. Unfortunately, there is no way to assess the precise magnitude or timing of that impact, and it is impossible to predict the fundamental equilibrium exchange rate that will emerge for the euro and the dollar. It would, therefore, be a mistake to use target zones or any other predetermined mechanisms to limit dollar-euro fluctuations during the transition period.

However, markets could become extremely unstable. It will be important for the G-7 and the International Monetary Fund to monitor events closely, to form judgments on the likely outcome as the process evolves, and to intervene to limit unnecessary volatility. This monitoring will require much closer cooperation than exists today.

Over the longer run, availability of a more attractive alternative to the dollar could reduce the ability of the United States to finance its large external deficits. With more than $4 trillion in external liabilities and an array of alternative assets available to international investors, however, the United States' policy autonomy already faces considerable limits. Such constraints were felt in Washington in the late 1970s—even though the United States was then the world's largest creditor country—when the dollar's free fall signaled the need to tighten monetary policy and triggered the $30 billion dollar support package of October 1978. They were felt again in early 1987 and early 1995 when the dollar fell sharply against the deutsche mark and the yen.

European countries already pay relatively little attention to fluctuations in their national currencies vis-à-vis the dollar. But external events will play an even smaller role in the larger, unified European economy. Larger and even more frequent changes in the exchange rate of the euro could be accepted with equanimity. The EU might even promote greater currency movements to achieve external adjustment, as the United States has done on occasion.

The euro and the dollar will dominate world finance, but both Europe and the United States will often be tempted to practice benign

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neglect. If left to market forces, the two currencies will likely experience increased volatility and misalignments. Both outcomes would be destabilizing for other countries and the world economy.

The European Union and the United States must recognize that prolonged misalignments would be costly for their economies too. The United States learned this in the mid-1980s, when dollar overvaluation caused an extended recession in manufacturing and agriculture. Given the pivotal role of the EU and the United States in global trade policy, such lapses would be extremely harmful to the world economy. A structured exchange rate regime should be developed to manage the relationship that will emerge between the dollar and the euro. The EU, Japan, and the United States should negotiate a target zone system with broad currency bands, perhaps 10 percent on both sides of a nominal midpoint, that would avoid large current account imbalances and their attendant problems.

Many Europeans believe that EMU will facilitate such cooperation. Europe will speak with a single voice, enabling it to force the United States to be more cooperative. Some Europeans view this outcome as an important goal of EMU, and one that will offset the continent's enhanced ability to ignore external events.

Trade policy provides support for their logic. The multilateral trading system has been essentially bipolar since the creation of the Common Market in 1958, which has always spoken with a single voice on most trade matters. The united Europe could have chosen to raise barriers against the world, with only modest costs because of its considerable size, but has largely opted to support further global liberalization. Most observers believe that this negotiating structure facilitated the success of the three major rounds of the General Agreement on Tariffs and Trade. It has recently been on display in the forging of the two most important liberalizing measures since the end of the Uruguay Round, the agreement on trade in telecommunications services and the Information Technology Agreement on trade in high-tech goods.

While this pattern may hold, several scenarios can be envisioned. The United States could react defensively to its loss of monetary dominance and seek to create a formalized dollar area, like the United Kingdom's sterling area in the 1930s. The EU could adopt a

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strategy of benign neglect, arguing that the United States has done so repeatedly and that its turn has now come. Trade protection could result from either course.

When French President Valéry Giscard d'Estaing and German Chancellor Helmut Schmidt decided to create the European Monetary System in 1978, one of their goals was to foster a more stable global monetary regime. The creation of EMU could bring that vision closer to reality. However, in the absence of cooperation between the European Union and the United States, the euro could create greater instability. It is up to the governments of the two regions to achieve a smooth transition from the sterling- and dollar-dominated monetary regimes of the nineteenth and twentieth centuries to a stable dollar and euro system in the early 21st century. The underlying strength and history of the North Atlantic relationship bodes well, but achieving a successful outcome will be a major policy challenge in the years ahead.

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Making Foreign Aid Work

Carol Graham and Michael O'Hanlon

NO PAIN, NO AID

FOREIGN AID is facing difficult times. Even some aid practitioners have called its effectiveness into question. While aid has had success in humanitarian relief, family planning, and reducing infant mortality, its record in promoting economic growth has been mixed. Economic growth is not the sole objective of U.S. foreign aid, and it may be the least important goal for policymakers concerned with security, short-term solvency, human rights, or democracy. But the effects of aid on growth can be measured empirically, and growth is a necessary condition for meeting most of the broad objectives of aid.

While aid has succeeded in promoting growth in some countries, in many others it has failed or even been counterproductive. A number of countries, many in sub-Saharan Africa, are poorer than when they began receiving aid several decades ago. Donors have often subsidized unsound economic policies. In such situations, foreign aid has perpetuated poor policies and weak economic performance. The solution is not to end or even reduce aid flows, but for donors to allocate resources more selectively.

In the 1960s and 1970s, aid was driven primarily by the security concerns of the Cold War, with an underlying focus on reducing poverty. During the debt crisis of the 1980s, the rationale for aid shifted to

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CAROL GRAHAM is a Visiting Fellow and MICHAEL O'HANLON a Research Associate in the Foreign Policy Studies Program at the Brookings Institution. Graham is also a Special Adviser to the Executive Vice President of the Inter-American Development Bank. They are coauthors of the April 1997 Brookings study *A Half Penny on the Federal Dollar: The Future of Development Aid.*

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limiting the liability that developing country debts increasingly placed on the international economic system. Concerns about reducing poverty also resurfaced, but a new emphasis on promoting democracy and human rights complicated those sentiments. In the 1990s these rationales are joined by new priorities such as supporting export markets in developing countries. It is not clear that aid can achieve all these goals simultaneously; at times they may work at cross-purposes.

It is clear, however, that the manner in which the United States conceptualizes and evaluates aid has changed dramatically. Decades ago donors saw aid as a transfer of resources from rich to poor countries. Today they see it more as a means to improve the use of domestic resources in recipient countries. The focus of aid has changed from development-related projects in health, education, and agriculture to encouraging the adoption of growth-oriented fiscal, trade, and monetary policies.

While convincing governments to implement development projects, particularly when donors provide the bulk of the resources, is not difficult, convincing them to implement a new macroeconomic framework requiring painful fiscal adjustments is no small task. The politically unpopular costs of these policies are visible up-front. But the benefits of sustained growth tend to become visible only in the longer term. Donors' skepticism about recipients' fiscal discipline has led to a growing reliance on conditional aid, and the conditions placed on multilateral development bank loans increased markedly during the 1980s. But these conditions can be difficult to implement. While compliance with some conditions, such as the stabilization of inflation or the devaluation of the exchange rate, is easily measured, it is much more difficult to assess and enforce others, such as progress in reforming the tax system or civil service.

Several studies in the 1990s have found no positive relationship between conditioned financial aid and economic growth. Some assessments even find a negative relationship, particularly in low-income countries. Yet these studies acknowledge that the broader policy orientation that foreign aid seeks to promote—open economic policies with prudent fiscal management—is producing strong results worldwide. While some countries with little or no external aid have had strong

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growth performance due to market-oriented policies, others, despite increasing levels of conditional aid, continue unsound economic policies.

LESS IS MORE

AVERAGE AID-TO-GNP ratios suggest that countries that receive greater amounts of aid do not grow faster than those that receive less. For example, African nations have aid-to-GNP ratios more than ten times that of either Latin America or East Asia, but still suffer inferior economic performance. Within Africa, countries with poor economic policies have received more aid per capita than those with responsible policies. While some studies of World Bank lending find a negative correlation between aid flows and growth, other studies, using broader measures of aid flows, find that aid on average has no effect on growth.

There are multiple explanations for these findings. One is that aid flows remove a hard budget constraint, postponing the need for domestic consensus on economic adjustment. Such a consensus is important in developing public support for reform, as well as a commitment to prudent economic policies among policymakers, which is often referred to as "ownership." A recent World Bank review found that 44 percent of adjustment loans associated with a high degree of ownership had satisfactory economic performance, and 28 percent had unsatisfactory performance and a low degree of ownership.

World Bank economists Michael Bruno and William Easterly recently came to a similar conclusion, albeit in a different fashion. Among a sample of 55 developing countries, those where inflation reached crisis levels of more than 40 percent initially suffered a drastic drop in growth, but recovered quickly after prices stabilized. These countries achieved and maintained growth rates higher than before their inflationary crisis. In contrast, countries that muddled along at slightly lower inflation maintained lower growth rates.

The political side of this story is that the inflation crises gave governments the latitude to implement reforms—trade liberalization, pension reform, the introduction of independent central banks—that are essential to sustained growth. Lower-inflation countries did not feel domestic or external pressure to change their policies. In the

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high-inflation countries, aid diminished before the onset of the financial crisis. In the low-inflation countries, grants increased sharply over time. And of the 19 low-inflation countries, 11 were in the franc zone, where inflation has been kept artificially low by a unified exchange rate that is pegged to the French franc and subsidized by substantial amounts of bilateral aid. The franc zone countries have had slow growth and high poverty.

Equally important is how governments use aid. A recent study of 97 countries conducted by economist Peter Boone found that nearly all foreign aid goes to government consumption and has little impact on investment or growth. Aid's record is much better when appropriate policies are in place. One World Bank study found that aid increased growth in countries with open trade, low inflation, and a fiscal surplus. But growth performance rarely determines how aid is allocated. Donors' strategic interests are usually more decisive than any interest in rewarding responsible policies.

Suggesting that more countries be allowed to slip into crisis, however, is not an acceptable policy recommendation. Crises cause widespread suffering and are not always resolved peacefully. Moreover, aid or the prospect of aid can play an important role in the consolidation of a reform-minded government. In Poland in 1989, external support was a benefit that the reform team could deliver and that was vital to its political ascent. Still, too much aid flows to countries that are unable or unwilling to implement necessary reforms.

KNOWING WHEN TO SAY WHEN

AWARE OF these dangers, lenders in the 1980s began to offer conditional loans. Conditionality implies a contract between a borrower and a lender, usually a multilateral institution like the World Bank, that provides credit at below-market rates. The "grant" element of these loans varies according to the country's risk. While a particular interest rate might not be considered a grant for a low-risk country like Korea, it would be concessional for a high-risk country like Zambia, which would pay much higher market rates. The International Development Association, the World Bank's soft-loan window, provides interest-free credit for the poorest countries.

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FOREIGN AID DONATIONS BY OECD COUNTRIES, 1995

DONOR COUNTRY	NET ODA (CONSTANT 1997 $ BILLION)	ODA AS PERCENT OF GNP
JAPAN	15.1	0.28
FRANCE	8.8	0.55
GERMANY	7.8	0.31
UNITED STATES	7.6	0.10
UNITED KINGDOM	3.3	0.29
CANADA	2.2	0.39
ITALY	1.6	0.14
AUSTRALIA	1.2	0.34
FINLAND	0.4	0.32
LUXEMBOURG	.07	0.38

SOURCE: OECD, "FINANCIAL FLOWS TO DEVELOPING COUNTRIES IN 1995," 1996

Conditions for aid are usually applied ex ante, that is, borrowing countries must meet specific requirements to be eligible for a loan and then meet other conditions to receive subsequent loan payments. Weak borrower commitment compounded by poor donor confidence has led to a mushrooming of conditions. A high number of technical conditions can be difficult to comply with, particularly if there are unexpected political developments or external economic shocks. And the more numerous the conditions, the more likely that governments will avoid full compliance. In addition, when all policy measures are dictated from abroad, an important policy learning process is lost.

Donors have strong incentives to continue lending even when conditions have not been met. Ultimately, the World Bank must make loans to remain in operation. The average loan officer has more incentives to disburse approved loans than to enforce strict compliance with conditions. By the World Bank's own calculations, only 60 percent of agreed conditions are typically implemented during the first loan period, yet the second phase of a loan is almost always approved. The World Bank's wide exposure to a number of highly indebted countries in the 1980s gave it a stronger stake in preventing those countries' insolvency than in promoting policy reforms.

Many observers, and even some World Bank reports, have called for a reevaluation of conditional aid, moving toward more selectivity, fewer conditions, increased domestic involvement in aid programs, and stricter enforcement when conditions are not met. For conditions

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to be credible, they must be enforced across the board, which is far from the current practice.

A more fundamental shift in lending practices would change the criteria for conditional aid. Instead of applying detailed conditions at the beginning, donors and borrowers should agree on a general policy package. The borrower's implementation of reforms would determine the country's eligibility for future loans. This approach would avoid disagreements over specific measures, focus attention on the overall policy, and encourage "ownership" of policy reforms.

While a shift toward more selective lending based on countries' track records is intuitively appealing, it would entail substantial risk since it could result in the withdrawal of aid from many poor countries, particularly in Africa. Despite the potential social costs, a withdrawal of financial flows could generate a shift toward genuine policy reform in some countries. But there are likely to be instances where governments do not adopt reforms and economic performance deteriorates further. The social costs to these countries could be mitigated by continued flows of humanitarian aid and unconditional technical assistance to government or nongovernment actors.

Withdrawing aid could bring genuine reform in many countries.

Aid is most beneficial when it influences policy at the level of ideas. When reformist ideas are adopted by a critical mass within society, they tend to be implemented as policy. The experience of many East Asian countries in the 1970s and Latin American countries in the 1980s and 1990s supports this proposition. Donors who demonstrate a willingness to stop loans when poor policies are being pursued would put all borrowers on notice.

It is important to consider whether countries' economies perform poorly because of their initial conditions, such as per capita income and natural resources, or because they pursue inappropriate policies. According to the so-called convergence theory of economic growth, poor countries grow faster than wealthier ones due to a higher rate of return on capital investment. However, since the early 1970s some poor countries have experienced negative per capita growth. The disheartening performance of many poor countries, particularly in sub-Saharan

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Africa, has led some economists to give credence to theories of a "convergence club." To be a member, countries must have enough human capital to take advantage of modern technology. Initial conditions, this theory suggests, predetermine poor countries' performance—a pessimistic scenario for both poor countries and aid.

In a 1995 Brookings Institution paper, Harvard economists Jeffrey Sachs and Andrew Warner dispute this theory, arguing that policies matter more than initial conditions. Countries that fail to secure private property rights, that follow autarkic trade policies, and that maintain inconvertible currencies are unlikely to see convergence regardless of their production technology or initial endowment of human capital. In a study of 117 countries, Sachs and Warner found that market-based policies brought an overwhelming tendency toward convergence, even among countries that started with extremely low levels of human capital and per capita income. It was difficult to identify a single case in which a poor country protected private property rights and maintained economic openness yet failed to achieve economic growth. Few countries that pursued closed policies grew at equivalent rates and in a sustainable manner.

These results suggest that responsible policies are the most important factors behind performance, and that the greatest contribution aid can make to a country's well-being is to support the adoption of such policies. In most poorly performing low-income countries, ineffective policies have been in place for decades. In such countries, where political or institutional conditions stymie reform, external support can encourage change. Initially this support should not be in the form of substantial financial flows, but rather that of technical assistance, ideas, and the promise of financial assistance to come.

MENDING AID

THE EVIDENCE on aid and growth calls for much greater selectivity in allocating bilateral and multilateral aid. It will be difficult to meet any other objective—stability, democratic government, respect for human rights—without a sustainable macroeconomic framework that makes inroads toward reducing poverty. Available resources must be used more effectively to assist countries willing to follow sound economic policies.

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A drastic curtailment of overall aid resources is undesirable. In many cases the promise of future assistance helps forge a consensus on policy reform. It is important for donor countries to reward poor performers when they adopt appropriate policies. Those rewards should include not only financial flows but also debt forgiveness, open markets for trade, and private capital inflows. Most increases in foreign capital take place in fast-growing countries well into their reform process, not among those just launching reforms. Aid resources can encourage reforming governments to stick to their objectives and help cover transition costs along the way.

The United States' ability to administer aid is in danger.

A strategy of aid selectivity will entail its own short-term costs for donors. Cutting off poor performers is likely to result in some defaults on debt payments, losses that for the most part will have to be absorbed by multilateral institutions. And while cutting off aid may result in the formation of a reform-minded consensus in some countries, in others it may exacerbate social tensions beyond the crisis point, perhaps necessitating humanitarian intervention.

At present, the United States' capacity to administer aid is threatened. Under the recent balanced-budget deal, real international affairs spending will probably be reduced from $19.5 billion to $16.5 billion by 2002. Given these projections, official development assistance (ODA), which is almost half the international budget, at $9 billion, would drop to less than $8 billion. This reduction would contribute to an ongoing decline in global ODA donations and reduce the United States' contribution to less than 15 percent of all global aid, guaranteeing a decline in U.S. influence in multilateral institutions. While America was once the world leader in foreign assistance, it is now falling to fourth place behind Japan, Germany, and France. The United States devotes a smaller percentage of GDP to development assistance than any other member of the Organization for Economic Cooperation and Development (OECD). It is unlikely to convince other countries to adopt a new approach to aid when its own contribution is falling to historic lows.

Rather than cutting ODA, the United States should increase it by $3 billion to $12 billion per year, which would hardly bring it to an all-time high. Because other types of international spending would fall by $1 bil-

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lion under the president's budget proposal, a $3 billion increase would result in a $2 billion overall rise in the international affairs budget. The United States' ODA contribution would return to 0.15 percent of GDP, its level during the early 1990s. While the American contribution would remain below the OECD average of 0.35 percent of GDP, a lower than average aid-to-GDP ratio for the United States should be accepted, due to the U.S. military's unrivaled contribution to international stability. But maintaining global aid flows at adequate levels requires an increase in the American contribution. This funding would ensure that there are sufficient resources to help reforming countries as much as countries like Korea and Taiwan were helped in the past. It would also assist the United States in convincing other donors and multilateral institutions to adopt a more selective approach to aid—a strategy that will not succeed if the United States acts alone.

The recent consolidation of the U.S. Agency for International Development with the State Department will remove a political stumbling block to adequate financing of foreign aid. But it does not resolve the central issue of aid effectiveness, and therefore the concerns of aid's most vociferous critics. Leading the effort to make foreign aid more effective in promoting growth and reducing poverty in developing countries would be important in itself, and could go a long way toward reducing skepticism about an important foreign policy tool.

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Why North Korea Will Muddle Through

Marcus Noland

APPARATCHIK CAPITALISM

AFTER CONSULTING with their superiors, the guards at Rajin harbor allowed us to exit. Apparently two Americans on a morning jog were not thought to pose a grave threat to national security. As we ran up the hill overlooking the harbor, I noticed a small military installation. On our way down I watched two soldiers stealthily working their way through the dilapidated structures, eventually reaching an isolated corner of the base, far from their comrades. Like two characters from a B movie, the soldiers looked left and right before kneeling. One removed his knapsack and placed it between them in the dirt. He opened it and withdrew two . . .

Bananas. At that moment his colleague glanced upward and spied us on the ridge above. The soldiers leaped to their feet and turned their bodies to shield the bananas from our view. The presumably banana-laden knapsack was stashed at the base of a wall, and, checking that they otherwise had not been observed, the soldiers headed back toward the center of the base.

One can easily conjure up myriad interpretations of a surreptitious trade in bananas at an isolated North Korean military installation in the autumn of 1996. But any consideration of the state of the North Korean economy presents policymakers with two fundamental problems. First, there is an acute lack of information, a vast gulf between fragmentary anecdotal evidence on the one hand and highly uncertain

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MARCUS NOLAND is a Senior Fellow at the Institute for International Economics.

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estimates of economic aggregates on the other. Second, there is really no reliable theory linking economic distress or deprivation to political change. Even a reasonably persuasive analysis of the economy does not necessarily provide much guidance for political decision-making, much less for assessing the stability of the regime.

The North Korean economy is in bad shape, and a famine of unknown magnitude is under way in parts of the country, but it appears that minimum survival requirements can be maintained with little or no external support. Kim Jong Il's regime appears to have been largely successful in fusing *juche* (self-reliance) ideology to Korean nationalism, and unlike the countries of Central Europe, North Korea has no institutions capable of channeling mass discontent into effective political action.

Rather, in light of its domestic politics and geopolitical position, North Korea is likely to muddle through, along the lines of Romania in the 1980s, with support from China and possibly Japan and South Korea, which would like to avoid its collapse. Ironically, the reduction of North Korea to a dependency would represent the inversion of the ideology of its founder, Kim Il Sung, and a restoration of the status quo of much of the last millennium.

PROFITS FROM PACHINKO

THE NORTH Korean economy is organized like other centrally planned economies. Its distinguishing feature has been the extremes to which central planning has been taken under *juche* ideology. As a result, the economy is shrinking, but the margin of error for estimates of almost all economic aggregates of interest is on the order of hundreds of millions of dollars.

Foreign observers, including those from other socialist states, concluded that by the late 1970s the North Korean economy was experiencing serious problems when its ability to grow "extensively" through the mobilization of resources was reaching its limits. A series of macroeconomic shocks in the late 1980s—including the withdrawal of Soviet aid, economic disengagement with its former socialist allies in the Eastern bloc, and bad weather that worsened the crisis in agriculture—exacerbated those difficulties.

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Assessing the degree of economic distress in North Korea with any precision is difficult. Virtually all economic and social data are regarded as state secrets. A number of individuals and organizations have attempted to estimate North Korean national income, but figures cited in public discussions are invariably the official South Korean estimates produced by the Bank of Korea. Those figures are apparently derived by taking classified data generated by South Korean intelligence agencies on physical output and then applying South Korean prices and value-added coefficients to indexes of physical production. Because the original estimates of physical output are classified, there is little opportunity to check their plausibility, nor is it obvious that South Korean prices and value-added weights are the most appropriate. Furthermore, the final growth rate figure is reportedly subject to interagency bargaining within the South Korean government.

With help from China, North Korea can avoid more widespread famine.

With these caveats in mind, Bank of Korea data indicate that the North Korean economy shrank by roughly 30 percent from 1991 to 1996, certainly a significant amount, but not unprecedented for a transitional economy. However, the estimated fall in national income may well overstate the reduction in household welfare, since it is unlikely that such services as housing and education, which are undercounted in the socialist accounting system and are not amenable to physical measurement, have declined as much as manufactured output. These estimates of national income are therefore not necessarily indexes of hardship or political discontent.

Somewhat less uncertainty surrounds North Korea's external economic relationships. In principle one can obtain estimates of trade and capital flows by aggregating the data reported by North Korea's trade partners after adjusting for misreporting and transportation costs. Three conclusions stand out: North Korea runs large and chronic trade deficits, its trade is concentrated with a few partners, and, most telling, trade volumes are falling. If the deficits that North Korea runs with China—obtaining imports on concessional terms—and the surpluses that it runs with South Korea—generating export

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revenues—are considered in effect to be politically determined, China and South Korea together implicitly support most of North Korea's trade deficit with the rest of the world.

Still, North Korea appears to confront a financing gap on the order of hundreds of millions of dollars. Aside from exports, the largest source of hard currency earnings is probably remittances, principally from ethnic Koreans residing in Japan. Remittances have been variously estimated as the amount of currency that visitors from Japan could legally carry on their person, as profits from the pachinko industry, a form of gambling popular in Japan in which ethnic Koreans play an important role, and as the portion of the balance of payments that cannot be explained in other ways. Not surprisingly, given these varied approaches to tallying remittances, estimates of the annual total vary enormously, from the low millions to $2 billion, typically running in the hundreds of millions. The figure is probably less than $100 million, an assessment that Nicholas Eberstadt shares in his article in the May 1996 issue of *Asian Survey*.

In response to its current predicament, the regime has begun some modest and hesitant reforms, most notably the establishment of a special economic zone, modeled after China's southern and coastal provinces, in the far northeast of the country. But such tinkering, however politically contentious within North Korea, is unlikely to reverse the decline of the economy.

WITH A LITTLE HELP FROM CHINA

AN ALTERNATIVE approach would be to ask what level of external assistance would be required to maintain the North Korean population at a subsistence level. With help from the Chinese or others, North Korea can avoid widespread famine. If catastrophic famine does occur, it will be due to political decisions made in Pyongyang, not shortages of food.

The government's attempts at food self-sufficiency were wrongheaded and unsustainable. The bureaucratic collectivist nature of North Korean agriculture is decidedly inefficient and has involved the inappropriate cultivation of land and application of chemical fertilizers. The denudation of hillsides has contributed to soil erosion and worsened the flooding that has recently plagued the country, wreaking

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environmental damage that will take decades to repair. In any event, North Korea should be exporting mineral products and manufactures and importing food, not trying to achieve self-sufficiency.

A variety of organizations and individuals have analyzed the North Korean food situation, and the consensus is that North Korea is experiencing an annual grain shortfall of roughly two million tons. That shortfall is partly due to bad weather and flooding, but its roots are structural, and the provision of food aid is only a short-run palliative in the absence of fundamental economic reforms.

As with agriculture, a lack of information clouds the energy picture. North Korea relies on imported oil for fuel and fertilizer. Foreign exchange shortages and the reduction in subsidized supplies from Russia and China have squeezed oil imports, although there have been recent reports of arms-for-oil deals with countries in the Middle East. The electrical system relies primarily on coal and hydropower and is hampered by difficulties extracting increasingly inaccessible and low-quality domestic coal reserves. The power grid—largely underground for security reasons—is said to suffer from extraordinarily large transmission losses. The 1994 U.S.-North Korea Agreed Framework, which provides for fuel oil during the construction of light-water nuclear reactors and the rehabilitation of the electrical grid, will address some of these energy problems. Nevertheless, North Korea will need additional energy if it is to reattain its estimated 1991 level of electrical consumption.

The famine may be due to political decisions, not food shortages.

If these assessments of the agricultural and energy picture are correct and the Agreed Framework is implemented, the cost of purchasing shortfalls would not be very large, on the order of hundreds of millions of dollars. While anecdotal evidence suggests that both the central planning mechanism and the public food distribution system are fraying under the stresses of the ongoing crisis, these indications should not be overstated. The central government continues to act with a relatively high degree of coherence as well as the population's acquiescence. Starvation may be relatively localized and falling disproportionately on certain socioeconomic groups, particularly rural nonfarm workers, and could reflect conscious decision-making by the political elite.

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Indeed, the sums of money required for the survival of the population appear to be within the margin of error of what is known about the North Korean economy. It may well be that North Korea can subsist with no or relatively modest external assistance. In the short run, China, Japan, or South Korea could keep North Korea afloat. Both Japan and China appear to have surplus government grain stocks that could make up the North Korean shortfall at minimal expense. Food is already flowing from China into North Korea. Some represents grant aid, some represents state trading on unknown terms, and the remainder is commercial exchange. North Korea has also had some success procuring food through barter.

However, it should be reiterated that this analysis is based on highly fragmentary information. A famine similar to that which took place in China during the Great Leap Forward may be unfolding in North Korea, and some U.S. intelligence officials already put deaths from starvation in the tens of thousands. Some of the worst (and least understood) famines in this century took place in socialist countries where governments were able to restrict the flows of information and people both internally and externally. North Koreans have been conditioned by nearly two generations of extreme regimentation. Given the country's terrain and the instruments of social control at its disposal, the current regime plausibly could prevent the mass population movements observed during famines in Africa and the Indian subcontinent. If a widespread famine were to occur in North Korea, the killers would be cholera and miscarriages, not kwashiorkor, and outside observers might not learn its full magnitude until a decade hence. If such a famine materializes, its roots will be in political decisions made in Pyongyang, not material resource constraints.

BETWEEN SHOCK THERAPY AND THE PACIFIC WAY

The North Korean leadership faces three broad options: it can adopt fundamental economic reforms in an attempt to reverse the economic decline, recognizing that reform may unleash forces that threaten the character of the political regime; it can stand pat and try to ride out the current crisis, risking collapse; or it can muddle through, making ad hoc adjustments as circumstances dictate. In the

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end, North Korea will most likely follow Romania in a form of apparatchik capitalism in which growth will follow the initial decline in output that results from the relaxation of central control.

Reform

The reform option offers potentially enormous payoffs: North Korea could probably increase its output by more than half its pre-decline level under favorable conditions.[1] However, the reform path would not be easy. A variety of considerations suggest that North Korea is unlikely to undertake wide-ranging reforms of its own volition.

Crudely put, the conventional wisdom has it that there are two ways to reform a centrally planned economy—the successful, Asian, gradual approach, and the unsuccessful, European, "big bang" approach. According to this view, North Korea is an Asian country, ergo it will adopt the successful, gradual approach and grow ten percent a year upon the commencement of reform. But gradual reform of a centrally planned economy requires resources to cushion adjustment in the heavy manufacturing sector. Auspicious initial conditions may have benefited successful agrarian countries like China and Vietnam, where the state-owned heavy industry sector was relatively small. Those countries were able to initiate reforms in the agricultural sector, where price liberalization spurred rapid efficiency gains, freeing up low-productivity surplus agricultural labor to be absorbed by the emerging non-state or semi-private light manufacturing and service sectors. In theory, these new, expanding sectors could be taxed to provide state revenues to cushion the transition in the heavy industry sector (though in fact few such transfers have occurred). But the initial conditions in China and Vietnam were unique, and such a path does not appear to be viable for more industrialized centrally planned economies. Piecemeal reforms have not been successful in those economies when they faced economic crises. The more interdependent nature of industrial enterprises means that a host of reforms—macroeconomic stabilization, rational pricing, liberalization of international trade and introduction of a convertible currency, and overhaul of the tax system, bankruptcy laws, and the so-

[1]See Marcus Noland, Sherman Robinson, and Monica Scatasta, "Modeling North Korean Economic Reform," *The Journal of Asian Economics*, Spring 1997, pp. 15-38, forthcoming.

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DISTRIBUTION OF LABOR FORCE IN PLANNED ECONOMIES AT ONSET OF REFORM
(in percentages)

COUNTRY	AGRICULTURE	INDUSTRY	OTHER
USSR, 1987	19[a]	38[b]	43
BULGARIA, 1989	19[a]	47	34
CZECH REPUBLIC, 1989	11[a]	39	50
SLOVAKIA, 1989	15[a]	34	51
POLAND, 1989	7[a]	37	56
HUNGARY, 1990	15[a]	36	49
UKRAINE, 1990	20	40	40
BELARUS, 1990	20	42	38
ROMANIA, 1990	28[a]	38	34
NORTH KOREA, 1987	25[c]	57[d]	18
CHINA, 1978	71	15	14
VIETNAM, 1989	71	12	17

[a] — *agriculture and forestry* [b] — *industry and construction*
[c] — *farmers* [d] — *workers*

SOURCE: MARCUS NOLAND, "EXTERNAL ECONOMIC RELATIONS OF THE DPRK AND PROSPECTS FOR REFORM," PAPER PRESENTED AT THE CONFERENCE "NORTH KOREAN FOREIGN POLICY IN THE POST-COLD WAR ERA," COLUMBIA UNIVERSITY, JUNE 1996.

cial safety net—are a seamless web and must be carried out simultaneously to be economically successful and politically sustainable. Even in China and Vietnam, adjustment in the old state-owned heavy industry sector has proved difficult.

North Korea also faces the enormous ideological challenge posed by a prosperous, democratic South Korea. Once North Korea begins reforms, the state's raison d'être will be called into question. In Vietnam and China, Marxist ideologues were able to manufacture tortured rationalizations for market-oriented reforms. Maintaining such a façade is likely to be much more difficult for the North Koreans. The scale of change that will accompany significant liberalization is also likely to be tremendous. North Korea is probably the most distorted economy in the world. Liberalization would mean huge changes in the composition of output and employment. International trade would become far more important, and most of that trade would be conducted with South Korea and Japan, two countries with which North Korea maintains problematic political relations.

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Finally, it is hard to imagine North Korea undertaking significant reform without a more secure external environment. Although the military—probably the most coherent institution in the society, with privileged access to economic assets—could be a prime beneficiary of change, it may well oppose reforms that it believes endanger the nation's security. Economic reform is therefore unlikely to occur before some rapprochement with South Korea.

Collapse and Unification

The regime's second option is to stand firm and do nothing. Although this path promises short-run political stability, if current trends continue, economic distress will eventually put a significant share of the population in peril, if it is not already. Moreover, North Korea differs in some significant ways from other socialist regimes that were able to survive self-inflicted famines earlier in this century. First, the Kim government is not a revolutionary regime, but the dynastic continuation of a leadership that has held power for nearly 50 years. Surely neither this government nor the governed have the same capacity for enduring hardship that would accompany a period of revolutionary fervor. Second, North Korea is a relatively industrialized, urban society, which curtails both its government's ability to squeeze resources out of the agricultural sector and the populace's coping mechanisms. Third, previous socialist famines have largely been precipitated by the introduction of counterproductive policies and could be solved straightforwardly by their removal. North Korea's current agricultural problems appear to be less a function of bad weather or the sudden introduction of misguided policies than the culmination of two generations of bad policy.

Even if the North Korean regime appeared to be teetering on the verge of collapse, the costs of unification would be so great that the South would try to prevent it. The most obvious point of comparison is German unification, which has involved more protracted and costly transfers than analysts anticipated at the time of unification. Even with that largess, East Germany has gone through a wrenching transformation: unification and the depression that ensued brought a collapse in the birth rate unprecedented in German history, including the interwar years and the period of military defeat, and a dramatic

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rise in the mortality rate. Although some of the declines in marriages and births presumably represent delay, not permanent reduction, the same cannot be said for the increase in mortality rates.

In some ways Korea presents a gloomier picture than Germany. North Korea's population is about half as large as South Korea's, while East Germany's was one-quarter the size of West Germany's. North Korea's per capita income is only around one-seventh that of the South; East German incomes were one-third to one-half those of West Germany. North Korea's economy is probably more distorted than East Germany's was, and South Korea is not as rich as West Germany. On the other hand, the combined Korean population is younger than the combined German population, and the North Korean population is younger than the East German population, which should facilitate adjustment with lower social expenditures.

Unification of North and South Korea would cost about $1 trillion over 10 to 25 years.

Still, if South Korea were to absorb North Korea, the cost of unification, defined as the capital investment needed in North Korea to choke off the incentive for mass migration, would be on the order of $1 trillion—a figure so large as to be infeasible, even if spread over a time period of 10 to 25 years.[2] Even under optimistic scenarios, North Koreans will have powerful incentives to move to the South, and the potential for such migration is enormous: assuming that a person carrying some belongings could travel 20 miles a day, 40 percent of the population of North Korea lives within a five-day walk of the demilitarized zone. The level of migration will depend on whether political unification accompanies economic integration.

South Korea can discourage migration in two ways: by maintaining the demilitarized zone as a method of controlling population influx and by encouraging capital investment in the North to lessen the incentives to emigrate. While the former option is fraught with political difficulties—elected officials might hesitate before turning machine guns on a third of the electorate—the alternative has important implications for South Korean domestic policy. South

[2]Ibid.

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Korean policy will strive to minimize the burden imposed on South Korean taxpayers by financing the economic reconstruction of the North. This task will require policies to encourage foreign capital, specifically foreign private capital, to flow into North and South Korea. Historically, South Korea has been inhospitable to both foreign direct and portfolio investment. However, in this case liberalization not only would bring its traditional benefits but would facilitate private capital inflows to unified Korea, or alternatively substitute in South Korea for capital invested in the North prior to political unification. South Korea needs to continue to improve its foreign direct investment regime and encourage the development of efficient domestic bond markets that are capable of mobilizing large sums of capital when the need arises. The capacity to mobilize global private capital quickly will be important if economic integration is accompanied by political integration and South Korean laws and institutions are extended throughout unified Korea.

Some international public capital should also be available. The World Bank, for example, maintains a special program for peace and sustainable development in the occupied territories in the Middle East. A similar program, scaled to the much larger North Korean population, would imply World Bank investments of $4.4 billion annually. Furthermore, North Korea and Japan have yet to settle postcolonial claims. Taking the 1965 settlement between South Korea and Japan as a base and adjusting for changes in the price level, population growth, and accrued interest, the Japanese payment would be about $12 billion. These amounts are small, however, relative to the $1 trillion that would be required.

Muddling Through

Between the extremes of reform and collapse lies muddling through. Here the experience of Romania may be instructive. Romania and North Korea are similar in population, per capita income, social indicators, and sectoral distribution of labor, as well as central planning and its attendant maladies. Both combined rigid internal orthodoxy with symbolic independence in external affairs. Both experimented with socialism in one family; Nicolae Ceausescu's inspiration for the development of a cult of personality is said to have been a 1971 visit to Pyongyang.

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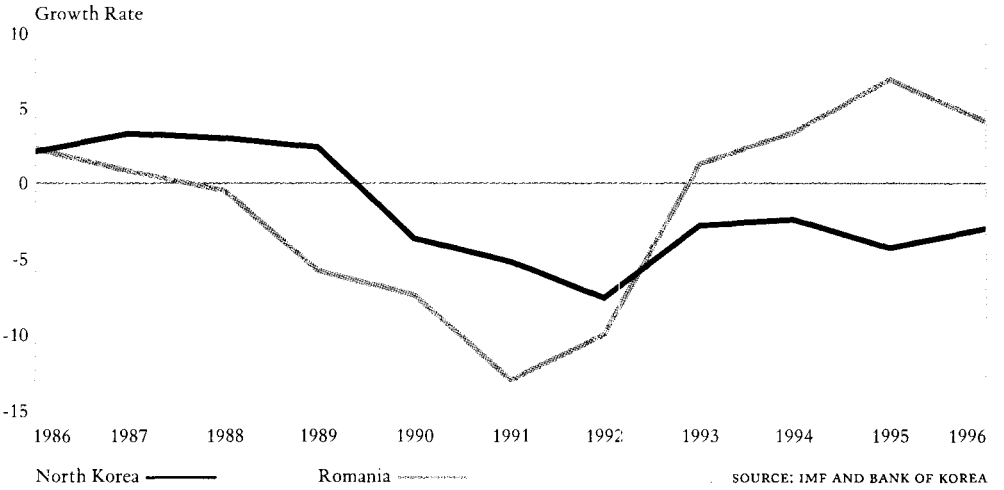
NORTH KOREAN AND ROMANIAN GROWTH RATES



Romania and North Korea both experienced economic problems in the 1970s as their central planning approaches began to fail. Although they were temporarily papered over by an inflow of recycled petrodollars, the underlying problems eventually manifested themselves in difficulties repaying accumulated external debts. One striking difference is that Ceausescu made the fateful decision to repay the debt, while Kim Il Sung defaulted on his Western creditors.

Romanian living standards began falling in the early 1980s as domestic consumption was compressed to free up resources for debt repayment, and conditions worsened in 1985, when the country was hit by severe weather during an energy crisis. Romanians were forced to live and work in freezing conditions, and draft animals were substituted for agricultural machinery. Nevertheless, mass unrest did not appear until 1987—six years after living standards began to decline—and it was not until 1989, with other socialist regimes collapsing and the economy going into free fall, that the Ceausescu regime toppled. That sequence of events suggests caution in drawing too deterministic a link between economic hardship and political failure, a caveat reinforced by the contemporary experiences of countries as diverse as Cuba, Iraq, and, until recently, Zaire. With the willingness of foreign powers to support North Korea's incumbent regime, that link may prove even more tenuous.

In Romania, Ceausescu's removal had more the air of a regime-preserving coup than a genuine revolution. Subsequent experience

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suggests that muddling through may indeed be a viable strategy. Both Romania and North Korea grew at a 2.5 percent rate in 1985. Romania subsequently suffered a sharper contraction in output than North Korea. However, once the reform process was initiated in 1990, the Romanian economy began to stabilize, and registered positive if unspectacular growth by 1993.

Similar economic and even political developments might occur in North Korea. The political and economic interests of the former Communist Party embodied in Ion Iliescu's recently ousted Social Democratic Party of Romania have strongly influenced that country's economic reform strategy. The state remains the dominant force in the economy. Political power is used to create and allocate excess profits that are channeled to politically influential groups and individuals, either openly or through corruption. Restructuring has proceeded at a slow pace. Kim Jong Il or his successor could well adopt similar policies to deal with economic hardship while satisfying the regime's political base. These favored constituencies would presumably be the Kim clique, the military, and possibly the upper echelons of the Korean Workers' Party. The regime could expect tutelage and material support from China, an advantage the temporizers in Romania did not have.

THE POWERS THAT BE

China, Japan, Russia, and arguably even South Korea may well prefer a muddling, domesticated North Korea to a capitalist and possibly nuclear-armed unified state on the Korean peninsula. China, Russia, and Japan may prefer continued economic engagement with South Korea and be willing to expend some resources to maintain North Korea as an allied buffer state. China has begun to pick up some of the slack left by Russia, North Korea's former patron, though the extent to which Chinese exports of food and other essentials are on concessional terms is unclear. Nor is it known what kind of economic or foreign policy conditions are attached to these exports. Beijing's dual goals of continued support for the North and enhanced economic engagement with the South is a delicate diplomatic conundrum, as was starkly apparent during the February defection of high-ranking North Korean official Hwang Jang Yop in the Chinese capital.

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Hwang's defection has made North Korea more suspicious of China's intentions and complicates the potentially constructive role China could play vis-à-vis the North. Yet North Korea's diplomatic isolation is so profound that even a China walking a diplomatic tightrope between the two Koreas is still likely to be the North's most effective patron.

Unification along the lines of the German model would complicate strategic planning for China and Japan and further reduce Russian influence in the region. One can envision China giving North Korea aid and technical assistance, South Korea engaging China and possibly North Korea economically while protected by the American security umbrella, and concerns over a Sino-Japanese military imbalance submerged by the American counterweight.

The United States would bear little of unification's direct costs, and unification would hold the promise of eliminating the direct threat posed by North Korea to American troops stationed in northeast Asia and the prospect of ending North Korean proliferation of weapons of mass destruction. While there may be some benefit to the United States in playing the security role outlined above, long-run U.S. interests are surely better served by unification. In this regard the United States may be unique.

North Korea is not Romania, and such analogies should not be taken too far. A prosperous, democratic South Korea will make it much more difficult for Kim Jong Il to pursue apparatchik capitalism as a development strategy. Even in Romania, Iliescu's party was driven from power last November. Nor do ad hoc measures ensure success—some of the muddlers among the states of the former Soviet Union have experienced declines in output of 50 to 80 percent. Nevertheless, the experience of Romania suggests that North Korea may muddle through for years before turning toward reform or chaos, especially if external powers find this solution to be in their interests.

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Indonesia After Suharto

Adam Schwarz

CAN CHANGE BE PEACEFUL?

As President Suharto eases into his fourth decade of power over the world's fourth-largest country, the Bapak Pembangunan, or Father of Development, can pride himself on Indonesia's economic transformation. Routinely hailed by the World Bank as a model developing country, Indonesia posted another banner year last year; the economy grew 7.8 percent, slightly more than the annual average since Suharto's rule began in 1966. Exports reached $50 billion in 1996, double the 1991 volume. At current rates of growth, Indonesia could become the world's sixth-largest economy by 2010.

During Suharto's tenure, tens of millions of Indonesians have been rescued from poverty. A burgeoning middle class in the cities of Jakarta, Surabaya, and Medan lives in fancy new apartments and shops in gleaming malls. Foreign investors pour billions every year into new factories, putting the sons and daughters of poor farmers to work making everything from Reebok sneakers to Sony televisions. A stable and increasingly prosperous Indonesia provides ballast and leadership to the Association of Southeast Asian Nations, with Suharto playing the role of the region's elder statesman.

Indonesia has changed almost beyond recognition from the impoverished, fractious nation, distrusted abroad, that it was under Suharto's predecessor, Sukarno. The Sukarno era (1945-66) was defined by jockeying for power among three factions, one of them the

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Adam Schwarz, Jakarta correspondent for the *Far Eastern Economic Review* from 1988 to 1992, is the author of *A Nation in Waiting: Indonesia in the 1990s*. He is currently a Visiting Fellow at the Paul H. Nitze School of Advanced International Studies at The Johns Hopkins University.

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Indonesian Communist Party, then the world's third-largest communist organization. Those strife-ridden years and the transition to the Suharto regime—during which as many as half a million real and imagined communists died in communal violence that wiped out the Communist Party—left Indonesians wary of conflict. Suharto's New Order government has worked assiduously to create the image of political stability and communal harmony that has earned the country the reputation of a safe haven for foreign capital. To get there, it abridged civil and political liberties and turned democratic institutions into hollow shells.

Recent unrest has shaken the aura of stability. The government's ouster of the elected leader of a political party triggered riots last year in the capital, Jakarta. Other rioters burned Christian churches and attacked ethnic Chinese, and tribal people clashed with Muslim settlers on one of the outlying islands. The awarding of the 1996 Nobel Peace Prize to East Timor's Bishop Carlos Ximenes Belo and independence spokesman José Ramos-Horta thrust Indonesia's troubled colony back into the international spotlight. Campaigning for parliamentary elections this May was repeatedly marred by clashes between rival groups frustrated by the strict limits placed on public debate. Indonesia's creaky political system appears incapable of accommodating mounting economic, religious, ethnic, and regional tensions.

In a rapidly changing society, half of whose members were born after Suharto came to power, political institutions stand still. The regime has outlived its usefulness, many Indonesians say. Disillusioned professionals and intellectuals declare that economic growth is no longer sufficient compensation for their lost rights. Workers, students, and younger activists increasingly turn to unlawful and violent action to express their discontent. Even many of the president's former allies describe him as aloof and out of touch. "Suharto is a true dictator now," says a wealthy businessman who not many years ago counted himself an avid supporter.

Suharto sits astride the political edifice with his powers very much intact. He retains the support of the military and full control over the levers of bureaucratic power. His opponents, including some disaffected officers, are deeply divided. And much as many Indonesians long for movement on the political front, they also harbor enormous

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misgivings about what will happen after Suharto, now 76, is gone. That is especially true of the growing middle class, which sees its fortunes as entwined with those of the regime.

But if major political change is unlikely anytime soon, so is political peace. With each new effort to quash popular calls for greater accountability, Suharto diminishes the chances for a peaceful presidential succession as well as hoped-for liberalization. The small businessman disgusted about losing a contract to one of Suharto's relatives, the farmer paid a pittance when he is forced off land slated for development, the teacher beaten by the police for disciplining a corporal's son have no legal recourse for their grievances. In such a climate the wealthy take their capital offshore, while the poor burn and loot.

OPEN AND SHUT

In the late 1980s and early 1990s, Indonesians watched with rising anticipation as the Iron Curtain fell and the totalitarian regimes of Eastern Europe tumbled. The emergence of democratic governments in South Korea, Taiwan, Thailand, and the Philippines undermined claims by Suharto and other Asian authoritarians that democracy was not an "Asian value."

Suharto himself raised hopes by calling for a new era of *keterbukaan*, or openness. Under this Indonesian glasnost with its relaxed political and social controls, poets, legislators, unionists, and religious leaders voiced thoughts and grievances long bottled up. With almost unprecedented bluntness, the press tackled taboo subjects ranging from the business dealings of Suharto's family to the rustlings in some Muslim groups eager for more political power. Satirical plays poked fun at the dynastic ambitions of the First Family.

But the party ended almost immediately after Suharto's election in 1993 to yet another five-year term. The government maneuvered political opponents out of power, closed important publications, harassed and imprisoned labor leaders, outspoken politicians, and other activists. Many Indonesians now look back at the brief interlude of *keterbukaan* as an establishment trick to flush out and eliminate Suharto's potential rivals.

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Over the last 18 months, as Suharto has made clear that he will meet popular pressure for a more open society with renewed repression, there has been an upswing of violence. Nineteen ninety-six began with secessionist rebels kidnapping nine members of a scientific expedition in Irian Jaya and ended with a string of Muslim riots and church burnings in East and West Java provinces and battles between the native Dayak people and Muslim Javanese migrants in West Kalimantan province on the island of Borneo. This February as many as 1,000 more people died in further clashes between Dayaks and settlers. Around the same time, rioters attacked shops and houses near Jakarta owned by ethnic Chinese. Students, workers, and farmers have demonstrated repeatedly in Java, where 60 percent of Indonesians live, protesting police brutality, corruption, land confiscation, and the widening wealth gap.

Suharto has cultivated an image of stability for foreign investors.

In June 1996 the government dislodged Sukarno's daughter Megawati Sukarnoputri from her position as leader of the small Indonesian Democratic Party, one of only two authorized "opposition" parties. After taking over as party leader in 1994 Megawati had quickly become a popular figure, her calls for more government accountability and political pluralism winning the party a wide following among the young. Seeing this, Suharto's government prompted a rebel faction of the party to hold new balloting for party chief, from which Megawati was excluded. Under strict military supervision in the Sumatran city of Medan, party dissidents complied with government instructions and voted to reelect former party head Suryadi.

Disaffected groups of all stripes rallied to Megawati's cause. Megawati loyalists camped out in the Democratic Party headquarters building, on a quiet, leafy street in central Jakarta, holding free-speech forums and demanding their leader's reinstatement. Hundreds gathered daily, many wearing motorcycle helmets in anticipation of a military assault. The government waited in vain for the furor to die down.

In late July 1996 military-backed thugs burst into party headquarters and forcibly evicted Megawati's supporters. The action triggered the worst rioting in the capital since 1974, when students rampaged through the streets to protest corruption and the growing links between major

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Japanese investors and ethnic Chinese businesspeople in Indonesia. In last year's riots, five people were killed, 149 injured, and 23 listed as missing; there was considerable damage to property downtown. The army's performance during the riots dispelled any remaining doubts about its willingness to act as Suharto's palace guard.

Megawati's relatively restrained response to her ouster disappointed many of her supporters, who had hoped for an open confrontation with the regime. She has taken her case to the courts, where it will no doubt languish for some time. The interference in its internal affairs has turned the Democratic Party back into what the regime wants it to be: a divided, disemboweled grouping whose sole function is to contribute to the form of democracy. But Suharto's reaction to a fairly weak, though popular, potential challenger shows how insecure his rule has become.

THE GREAT TABOO

OF THE many political taboos the Democratic Party broached, the most sensitive was presidential succession. In six meetings of a special assembly that chooses the president, dating back to the 1960s, Suharto has yet to face an opponent. Many believe it was the possibility of Megawati challenging him in the assembly scheduled for March 1998 that prompted the president to force her from the party leadership.

Since declaring independence from the Netherlands in 1945, Indonesia has had only one political transition, and it was one of the bloodiest of a bloody century. An attempted coup in September 1965 allegedly mounted by the Indonesian Communist Party was put down by the relatively unknown Major-General Suharto, the son of a Javanese clerk. The months of communal violence afterward imprinted themselves on Indonesians' memories. Playing off their fears of a repetition, President Suharto has reduced political strife by making it increasingly difficult for Indonesians to engage in political activity of any sort, however broadly defined. While preserving the trappings of a democratic state, Suharto has slowly bled democratic institutions of content.

Suharto emasculated political parties, made the parliament into a rubber stamp, slapped strict controls on the media and religious groups, passed labor legislation that made strikes virtually illegal, and shut down political venues on university campuses. His political

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party, Golkar, is little more than a patronage machine of impressive proportions. Suharto has expanded the military's political role, placing army officers in key ministerial and civil service positions and guaranteeing the military 75 of 500 seats in the parliament. Indonesians are allowed to cast a vote once every five years, but they are to steer clear of politics otherwise.

Peace and economic growth have prevailed, but Suharto's efforts to depoliticize Indonesia have all but eliminated the secular, moderate middle ground, leaving politics to be played only at the margins. "The greatest damage Suharto has done is to freeze political education at the kindergarten level," says an American academic who wishes to remain anonymous. "The failure to get people to buy in and to learn how to engage in compromise and conflict resolution without violence has carried a huge cost."

As the Australian academic Harold Crouch put it, "If a relatively small issue like the leadership of the [Democratic Party] can set off serious rioting in the center of the capital, what might happen if military and other factions cannot agree on the national leadership after Suharto?" Beyond the question of succession, the current holding pattern in Indonesian politics prevents resolution of a host of other problems.

THE NUMBERS CRUNCH

ECONOMICALLY SPEAKING, the Suharto regime has done many things right. It has used the country's oil wealth relatively wisely, investing in rural infrastructure, schools, and health clinics. By developing a manufacturing base before its reserves were depleted, Indonesia, unlike almost all other OPEC members, has avoided a crippling dependency on petroleum; oil and gas account for just over 20 percent of export earnings, down from more than 80 percent in the early 1980s. Lower tariffs beginning in the mid-1980s and a plentiful supply of cheap labor have combined to make the country a major exporter of light manufactures. Indonesia's political stability and skilled macroeconomic management led foreign investors to commit almost $30 billion last year alone.

But largely because of its ambitious 30-year industrialization project, Indonesia has accumulated worrisome foreign debt—around

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$110 billion—and has been running a current account deficit that is expected to reach about 4 percent of GDP this year. State-owned banks, overfond of lending to Suharto's friends and relatives, are saddled with an estimated $3 billion in bad debts.

Anxiety about keeping exports competitive while keeping youth employed is also creeping in. Labor costs are marching steadily upward—real wages have doubled in the last six years, to about 25 cents an hour—migration from rural areas to cities continues, and the population is growing at almost two percent a year. Officially, unemployment is a low 4.4 percent of a work force of 90 million. The World Bank, however, estimates that 38 percent of workers work less than 35 hours a week. And joblessness is much more common among the young: the 15-to-24 age bracket accounts for 20 percent of the work force but 70 percent of unemployment. In cities where conspicuous consumption by the rich has become the norm, there are now armies of idle youth.

What happens if the military and other factions cannot agree on the succession?

The urban poor are "the single most important factor in future Indonesian politics," contends Juwono Sudarsono, deputy governor of the National Defense Institute, a military-associated think tank. "It's the urban poor who are the most politicized, the most deprived, and therefore the most volatile, and it's not difficult to incite them to violence. It happened in 1974, it happened in 1996, and you may not have to wait another 20 years for it to happen again."

Labor unrest has soared in the 1990s as more workers moved into manufacturing. According to official statistics, only about 1,000 workers went on strike in 1989; in 1994 the figure was almost 150,000. Several new, unrecognized unions are taking on the All-Indonesia Workers Union, the sole government-authorized union. The government has felt the need to tread carefully with the new unions, since it is concerned about losing its preferential tariff rates with the United States, which supposedly depend on its upholding internationally recognized workers' rights, including the right to form unions. However, the regime has found other ways of keeping rebel labor leaders behind bars or under threat of being put there. Muchtar Pakpahan, head of the largest independent union, was arrested and convicted of

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inciting riots in Medan in 1994, and sentenced to four years in jail. The Supreme Court freed him a year later, citing a lack of evidence at his trial. But last year the Supreme Court elected to hear the case again, a decision many Indonesian analysts believe was ordered by Suharto personally. This time it found Pakpahan guilty.

Meanwhile, with wages increasing faster than productivity, labor-intensive industries, especially in light manufacturing, are feeling the pinch. A 1996 World Bank report warned that rising minimum wages were slowing job creation, and advised Indonesia to restrain wages.

Labor leaders retort that the government should instead attack the causes of the high cost of doing business in Indonesia, including cartels, weak law enforcement, and corruption. Making workers shoulder the burden of keeping exports competitive, they say, is unfair, and a recipe for labor unrest. Unfortunately for workers, it is easier to keep a lid on wages than to fix market distortions. As their industries' competitiveness declines, owners of clothing, footwear, and other labor-dependent factories will have greater incentive to try to get around minimum wage regulations. That in turn will worsen labor strife.

The regime has offered workers some concessions—introducing government-financed health and accident insurance and mandating an annual bonus equal to one month's salary—but has stuck to its strategy of firmly controlling labor unions. Far from ensuring industrial peace, this has turned the income gap and the perception of inequity into potent rallying cries for the opposition.

A TRADITION OF CORRUPTION

In annual surveys, business executives rank Indonesia among the region's most corrupt nations, along with Asia's two reforming communist countries, China and Vietnam. From paying small bribes for a driver's license or identity card to shelling out huge sums to secure major construction contracts, corruption is a way of life in Indonesia.

Contracts, exclusive licenses, and state loans are doled out among the president's relatives and a handful of his ethnic Chinese cronies. Taking their cue from Suharto, ministers, regional military commanders, and governors develop their own patronage networks. "Like a mafia boss," says a politician who supports Megawati,

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"Suharto protects himself by making everyone around him corrupt." As the Suharto era slowly winds down, the president's associates are grabbing sweetheart deals while they can.

Before Indonesia's limited privatization campaign began in the late 1980s, the flow of spoils to Suharto connections was considered unseemly but not economically significant. But privatization in many cases has been little more than a transfer of assets to Indonesia's political elite, with only a modest increase in competition. The business activities of the president's six children, a grandchild, sundry other relatives, and Chinese associates have grown spectacularly over the last decade. Foreign investors wanting in on any major infrastructure or mining project these days are forced to seek a partner among the inner circle.

The poor, the landless, and many youths feel Suharto's development has passed them by.

The rampant corruption impedes development. A Western economist calls it "a tragic form of regressive taxation. The poor pay higher prices because of all the monopolies, and they have to pay off government officials for everything they need." Corruption sets a tone in the business community, discouraging entrepreneurialism and encouraging underhanded practices.

Corruption also erodes Suharto's legitimacy. "Suharto's children seem to have no idea they are inviting a revolution," says a prominent political analyst. Even the normally apolitical middle class gets exercised about the preferences the business elite enjoy. Groups ranging from student associations to Muslim organizations to the Indonesian Democratic Party have used the issue of corruption to bolster their case for political change.

FAR FROM JAKARTA

DIVERSITY IN Indonesia is a source of both strength and tensions. A bewildering variety of ethnic, religious, and tribal groups speaking hundreds of languages live on thousands of islands spread out over the distance from London to Baghdad. Indonesian culture is one of the richest on earth. But each group that contributes to it contains seeds of political discord.

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The government has been fighting an insurgency in East Timor since it annexed the territory in 1975-76; there were accusations of Indonesian genocide against the Timorese during the early years, and in 1991 troops massacred several hundred peaceful demonstrators in Dili, the capital. Separatist sentiment also exists, to a lesser degree, in Aceh province, the country's most staunchly Muslim, and in Irian Jaya, the easternmost island. These regional disputes with Jakarta are fundamentally political. But the upheavals last year and this year in West Kalimantan demonstrate that economic disparities are now causing considerable alienation in some parts of the country.

Thirty years of development in Indonesia has lifted all boats, but poverty remains more common on the outer islands than in Java or Sumatra. Seven of the country's eight poorest provinces, as measured by World Bank figures for per capita consumption, are on outer islands. People on the sparsely populated Irian Jaya have long contended that most of the profits from the oil, gas, tropical wood, copper, and gold extracted locally go to the relatively well-off Java and Sumatra. Statistics bear them out. Irian Jaya's per capita GDP is one of the highest among Indonesia's 24 provinces, but in terms of per capita income and consumption, the Irianese are at the bottom of the heap.

Many economists argue that the only way to reduce such disparities is to decentralize economic decision-making and give local officials more say in the design of programs to alleviate poverty. The need to do so will become all the more important as the central government's oil monopoly brings in a diminishing share of revenue and a larger share comes from local sources. So far, the few decentralization efforts under way have not made many inroads on the concentration of power in Jakarta.

THE INDONESIAN-CHINESE

THE ISSUES of economic inequality, ethnic tension, and corruption intersect in Indonesia's community of ethnic Chinese. Although people of Chinese origin account for less than 4 percent of the population, they dominate the economy. Suharto's authoritarian rule, which dilutes the demographic weight of Indonesia's *pribumi,* or indigenous, majority, serves the ethnic Chinese well. Enjoying presidential patronage and

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protected from populist reprisals by their links with military and government leaders, several dozen ethnic Chinese families have amassed great wealth. Some surveys suggest that ethnic Chinese control between two-thirds and three-quarters of private sector activity. The growing middle class includes a disproportionate number of ethnic Chinese.

Indonesian-Chinese have as few political rights as the *pribumi*—indeed fewer. They are not allowed to form political associations, and most face discrimination when trying to enter the military, top universities, or the civil service. Few Chinese-language schools are permitted, and these must steer clear of teaching Chinese politics or culture. Advertisements in Chinese are forbidden.

In a sense, however, Indonesia's policymakers are hostage to the ethnic Chinese, whose firms provide hundreds of thousands of jobs and produce a sizable share of output: if Indonesian-Chinese were to slow down new investment or diversify overseas more aggressively, the economy would suffer. Thus the group has usually been able to fend off measures that would hinder business operations.

The economic power of the ethnic Chinese is a sensitive subject for the *pribumi.* Riots in Medan in 1994, in Tasikmalaya in 1996, and near Jakarta in 1997 were sparked by other grievances but quickly took on an anti-Chinese flavor. Several ethnic Chinese were killed, and Chinese shops, cars, and houses were looted and burned.

To the extent that animosity is aimed against the ethnic Chinese in Indonesia, it is against the elites who own the enormous, urban-based conglomerates. But they and their wealth are out of reach, as are Suharto's relatives, who have done their bit to exacerbate the growing economic frustration. That leaves poorer, mainly rural ethnic Chinese as scapegoats for both the rich Indonesian-Chinese and the government that abets them.

THE MUSLIM MAJORITY

THE ANOMALY of an ethnic majority that feels it is treated like a minority is mirrored in the relationships between and within Indonesia's religious communities. Almost 90 percent of a population approaching 200 million is Muslim, giving Indonesia the world's largest Muslim community; scattered Christians, Hindus, and Buddhists account for

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ARCHIVE PHOTOS

Father of Development Suharto, 1997

the rest. But Muslim leaders often sound and act like members of a persecuted minority. That is partly because Christians have held many important government and military posts during Suharto's tenure. More fundamentally, there is, in a practical sense, no Muslim majority; instead, there are a handful of Muslim minorities.

One segment of the community strives for greater political clout for Muslims. Only its radical fringe wants Indonesia to become an Islamic theocracy, but many in this camp believe the government

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should openly embrace Islam as the country's moral and ethical guide. In addition, these Muslims insist that the country's main political institutions, the army and the bureaucracy, adopt a policy of proportional representation: in other words, Muslims should get 90 percent of the jobs. The best-known organization representing this viewpoint is the Indonesian Association of Islamic Intellectuals (ICMI). Headed by a trusted Suharto lieutenant, B. J. Habibie, this mixed bag of clerics, bureaucrats, and political activists has gradually come to be seen as part of the ruling establishment. Some say Suharto supported its emergence to offset his weak backing in the military.

Members of Indonesia's largest Muslim group, the 30-million-strong Nahdlatul Ulama, also take their religion seriously, but are more supportive of the official policy that keeps politics and religion separate. The group's leader, Abdurrahman Wahid, has blasted Suharto for legitimating, with ICMI, the very Muslims who, in Wahid's view, are most likely to foster religious intolerance and erode religious harmony.

Religious intolerance has been much in evidence lately. Muslims rioted in October in the East Java city of Situbondo after a man convicted in a civil trial of blasphemy against the Prophet Muhammad received a sentence of only five years in prison—the legal maximum. Some 20 churches were burned and five people died. In December, in the West Java city of Tasikmalaya, Muslims burned another ten churches and a handful of Christian schools, killing four people. Christian sources say 60 churches were torched in 1996 alone, and up to 300 since 1990. Police brutality and economic injustice played a role in these disturbances, but Muslim community leaders, including those in ICMI, share the blame.

FEAR OF THE UNKNOWN

THE SURGE in social unrest is hardly surprising given the dramatic changes in Indonesia over the last decade. Every year a greater number of people move from agriculture into the industrial or service sectors, which almost always entails moving from the countryside to the city. At the same time, rising incomes, increasing educational levels, and

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the revolution in communications technology have enabled millions to see and learn about the outside world.

When politics cannot respond to and mediate social ferment, frustration builds. The experience of the Democratic Party last year convinced many Indonesians that peaceful political change is impossible within the existing rules. A new generation of activists in student and nongovernmental organizations is turning radical. Many are no longer afraid of the military, or of being labeled a communist or sent to jail on a political charge. The more extreme among them say open confrontation with Suharto and the military—demonstrations, strikes, and other forms of protest—is the only way to bring about real change in a system so entrenched. The alienated fringe would exile Suharto, haul his children up before an anticorruption commission, and bind over for trial in world courts military officers charged with violations of human rights in East Timor, Aceh, Irian Jaya, and elsewhere. The poor, the landless, and many disillusioned younger Indonesians feel that Suharto's economic development has passed them by, and they, having little to lose, don't mind rocking the boat if that might bring about change.

"We must find a way to never again have a 30-year president."

But while the causes the regime's critics espouse—an end to authoritarian rule, corruption, police brutality, and land confiscation, among others—are broadly popular, systemic change is unlikely in the near future. The opposition movement, such as it is, is weak and riven with distrust, and it is up against huge odds. Disparate groups came together briefly to protest Megawati's ouster, but their continued bickering shows how far they still are from a unified coalition.

Many leaders from the various Christian communities preach political liberalization yet fear that a more democratic government will allow Muslim groups to push Indonesia in the direction of an Islamic state. The Muslim community is divided in its views as well. Wahid, the Nahdlatul Ulama leader, lent his considerable prestige and influence to Megawati both before and after she was replaced as party head. On the other hand, some ICMI leaders who were ardent foes of Suharto when outside the system now seem more in-

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terested in securing jobs in the bureaucracy, or in working for greater "Islamization" rather than democratization, as Indonesia expert Douglas Ramage has noted.

Much of the middle class, which by some estimates now numbers between 14 million and 18 million people, is disgusted with corruption, but shies away from public expressions of dissatisfaction with the Suharto regime. Unlike their counterparts in the Philippines and Thailand, who played a pivotal role in the reestablishment of democracy, their commitment to political change is weak. As a Western ambassador in Jakarta says, "They still remember where they came from and they are not ready to risk a return to it."

An American executive who has spent many years in Indonesia neatly encapsulated the fears of middle-class and professional Indonesians: "Intellectually, I know it would be better for Indonesia if Suharto stepped aside," he said. "But . . . as a businessman, I want to postpone the day of reckoning for as long as possible."

Jakarta's version of the inside-the-Beltway crowd believes Suharto can still be persuaded to leave office gracefully, perhaps by appealing to his sense of history. Some argue that he should exercise legal veto power in the selection of his successor.

Many civilians who oppose Suharto, however, believe their only hope of unseating him is an alliance with disaffected military leaders. As the strongest institution in Indonesia, the military is certain to play a crucial part in the immediate post-Suharto period. But while individual officers may be sympathetic to those pressing for political change, the military remains a reactive, conservative force. It too fears a strengthening of political Islam, and is thus unlikely to lead or even participate in any movement against the current regime.

But many Indonesians feel that the political system Suharto built is in dire need of an overhaul, and they can broadly agree on the required changes. To remain competitive in an increasingly globalized economy, Indonesia must develop laws that both reduce corruption and create a more level playing field for business. Cartels and restrictive trade practices that benefit Suharto's relatives and cronies must be dismantled. To make the executive branch more accountable, more power must be given to the legislative and judicial branches of government. The military's role in day-to-day politics must be curtailed. Finally,

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as one political analyst in Jakarta put it, "We must find a way to never again have a 30-year president. Once is enough."

Since a stable Indonesia is vitally important to the entire region's security, concern is growing in neighboring countries over the uncertain succession. A period of turbulence in Indonesia could well disrupt the political cohesion of the region and retard plans for regional economic integration.

But change will necessarily be difficult in a country where political institutions are mere husks and normal political debate and negotiation are forgotten arts. Goenawan Mohamad, the editor of the banned newsweekly *Tempo*, says with a mixture of hope and trepidation, "When Suharto goes, everything will have to be reinvented."

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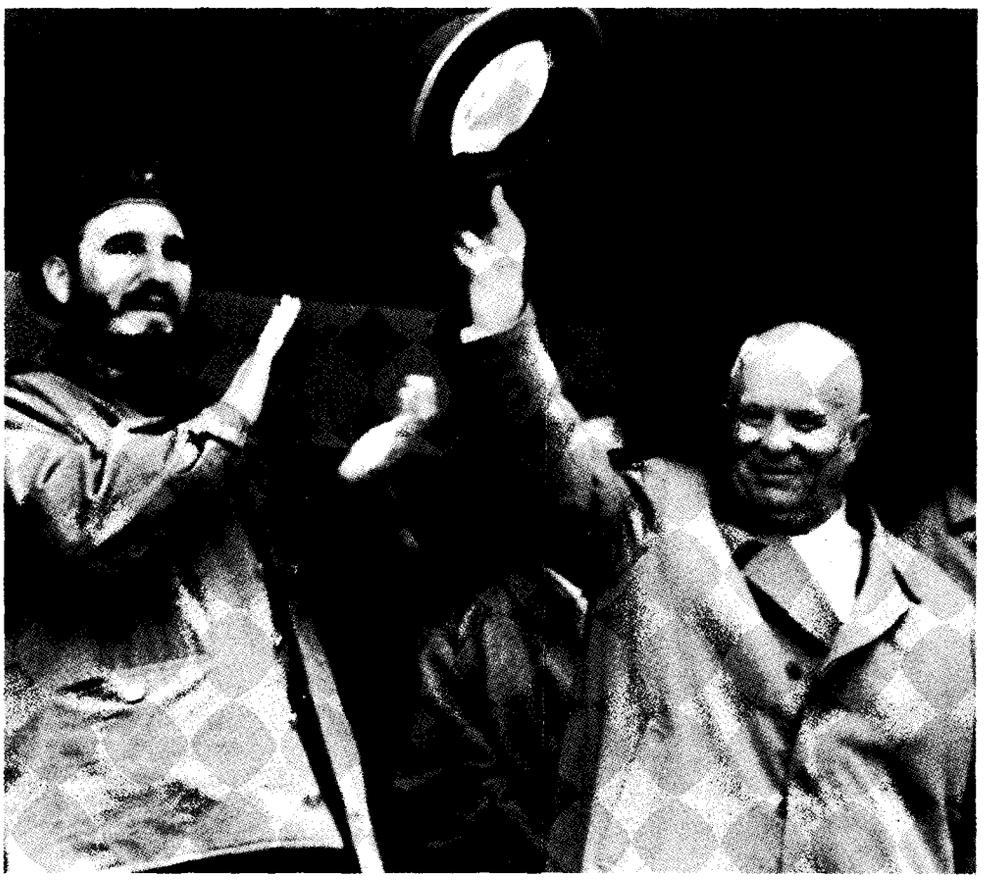

CORBIS-BETTMANN

Fidel Castro and Nikita Khrushchev celebrate May Day, 1963

Misconceptions about American intentions were the rule rather than the exception in the Kremlin.

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Review Essay

Seeking the Rule of the Waves

Paul Krugman

The Great Wave: Price Revolutions and the Rhythm of History. BY DAVID HACKETT FISCHER. New York: Oxford University Press, 1996, 536 pp. $30.00.

Books that propound theories of history—that is, that claim to find common patterns in events widely separated in time and space—have a deservedly dicey reputation among the professionals. When such books are good they can be very good: a classic like William McNeill's *Plagues and Peoples* can permanently change the way you look at human affairs. Most big-think books about history, however, turn out to offer little more than strained analogies mixed with pretentious restatements of the obvious. A few have been downright pernicious.

Still, the public has an understandably hearty appetite for theories that seem to explain it all, and so they keep on coming. *The Great Wave: Price Revolutions and the Rhythm of History*, by David Hackett Fischer, a professor of history at Brandeis University, has already generated considerable buzz. Remarkably for a book that spends most of its 500-plus pages dwelling on events centuries (and occasionally millennia) in the past, a good deal of the buzz comes from the business community, not usually noted for its interest in history. Indeed, Fischer is getting favorable mention from people who tell us in the next breath that we live in a "new economy" to which old rules no longer apply.

There is a reason for this peculiar affinity between a historian with an eighth-century perspective and business commentators obsessed with the new; what these pundits really want, it turns out, is to use his account of alleged patterns in the distant past as an excuse to ignore the lessons of more recent history.

PAUL KRUGMAN is Professor of Economics at the Massachusetts Institute of Technology.

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On its face, Fischer's book looks promising. Inflation is a plausible candidate for a wide-ranging search for parallels and common principles. And the book starts well, with an eloquent and stirring defense of the role of quantification in history (although my favorite along these lines is still Colin McEvedy's introduction to *The Penguin Atlas of Ancient History*, which contains this immortal sentence: "History being a branch of the biological sciences, its ultimate expression must be mathematical"). I plan to keep *The Great Wave* on my shelf both as a useful source of facts and figures and as a guide to data sources; the author did do a lot of homework.

It is therefore a shame that the book turns out to be quite wrong-headed. But let that not be too harsh a judgment: it is wrong-headed in interesting ways, and much can be learned by examining how and where Fischer went astray.

UNCONVENTIONAL WISDOM?

Fischer starts with an empirical observation: the history of prices in the Western world since the twelfth century can be broadly divided into alternating periods of generally rising prices and of rough price stability. Everyone knows that the twentieth century has been an era of inflation, and the prolonged price rise from 1500 to 1700 is also well known. Fischer makes a good case, however, that there were also reasonably well-defined eras of rising prices in medieval Europe before the Black Death and again in the eighteenth century.

What does conventional economic history have to say about these "price revolutions," as Fischer describes them? Well, the two familiar ones are generally attributed to increases in the supply of money, but with those increases themselves driven by very different factors. The long inflation from 1500 to 1700 is mainly attributed to the flood of silver from Spain's New World conquests; in the modern world governments can print money instead of mining it, and have done so repeatedly both to pay their bills and, more creditably, in an attempt to trade off higher prices for lower unemployment.

Fischer regards such explanations as inadequate. He insists both that inflation is only one symptom of a deeper process—a process that also produces growing population, rising inequality, declining real wages, and ultimately a crisis—and that this process is repetitive, that in a qualitative sense all price revolutions are alike. In particular, the travails of the West in recent decades are typical of the endgame of a price revolution—and we can take comfort in the fact that such difficult periods are inevitably followed by a prolonged "equilibrium."

This thesis is fun to contemplate and comforting in its implication that the worst may already be behind us. So what is wrong with it? One problem with *The Great Wave* is that Fischer displays a shortcoming common among historians writing on economic matters: he would clearly rather spend a year hunting down facts than a day mastering a theory, even if only to learn enough to reject it. As a result, his accounts of what he imagines to be the conventional theories of inflation—theories that he claims to refute with his evidence—are wildly off base, sometimes ludicrously so.

For example, at the very beginning of the book Fischer unwittingly reveals his unfamiliarity with even the most basic

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monetary economics when he attributes to Princeton's Alan Blinder the dictum that inflation is "always and everywhere a monetary phenomenon"—not realizing that when Blinder used the phrase in a newspaper article he was quoting Milton Friedman. Now Friedman's dictum, love it or hate it, is one of the three or four most famous tag lines in economics, right up there with "The division of labor is limited by the extent of the market" and "In the long run we are all dead." It is as if the author of a seemingly authoritative book about epistemology were to attribute the line "I think, therefore I am" to a modern philosopher who used it in an op-ed piece.

Fischer's impatience with analytical thinking extends to his own ideas; the book contains quite a few whoppers, assertions that fall apart if given even a moment's serious thought. His discussion of the origins of the great price rise after 1500 provides an illuminating example. Fischer points out, correctly, that prices in Europe began rising well before New World silver began to arrive—which, he argues, refutes any monetarist explanation. There is no mystery here: as he admits, there was a surge in European silver production in the late fifteenth century, mainly from mines in Bohemia and what is now southern Germany. (Coins stamped at one of those mines, in Joachimsthal, were circulated so widely that "thaler" became a generic phrase for any silver coin—and eventually, with some slippage in spelling and pronunciation, for pieces of green paper bearing George Washington's portrait.) But Fischer insists, without evidence, that the rise in European silver production was a result rather than a cause of inflation—that mines were opened and expanded to meet the "desperate need for liquidity" produced by rising prices.

Think about that for a minute. We can be sure that fifteenth-century German mineowners neither knew nor cared about about Europe's need for liquidity—they were simply trying to make a profit. Now ask yourself: does inflation (a rise in the price of goods and services in terms of silver) make it more or less profitable to open a silver mine? The clear answer is that it makes the mine less profitable: a pound of silver extracted from the mine would buy fewer goods and services than before. Had Fischer devoted even a few minutes to thinking his story through, he would have realized this. Yet the claim that rising prices necessarily induce increased creation of money is crucial to his whole theory.

THE REAL REVOLUTION

There is, however, an even bigger problem with *The Great Wave*. Like most efforts to derive lessons for the present from the broad sweep of history, Fischer's thesis essentially involves denying that the Industrial Revolution led to any fundamental change in the way the world works. But the fact is that beginning in the eighteenth century there was a qualitative change in the nature not only of economic life but of human society in general, a change more profound than any since the rise of civilization itself. That does not mean we have nothing to learn from earlier centuries. It does mean we have to be very careful in drawing parallels.

There are many ways in which the preindustrial world was another planet from the one we now inhabit, but in this

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context two changes are particularly crucial. First, for 55 out of the last 57 centuries Malthus was right. What I mean is that for almost the entire history of civilization, improvements in technology did not lead to sustained increases in living standards; instead, the gains were dissipated by rising population, with pressure on resources eventually driving the condition of the masses back to roughly its previous level. The subjects of Louis XIV were not noticeably better nourished than those of ancient Sumerian city-states. While they had enough to survive and raise children in good times, they lived sufficiently close to the edge that the Four Horsemen could carry them off now and then, keeping the population more or less stable.

It has been Malthus' great misfortune that the power of his theory to explain what happened in most of recorded history has been obscured by the fact that the only two centuries for which it does not work happen to be the two centuries that followed its publication. But this was, of course, not an accident. Malthus was a man of his time, and his musings were only one symptom of the rise of a rationalist, scientific outlook; another symptom of that rise was the Industrial Revolution.

Because Malthus was right, however, the great waves of economic activity in the preindustrial world were driven by forces that have little relevance to more recent fluctuations. In particular, the most important discipline for understanding long swings in preindustrial population and real wages is not macroeconomics but microbe economics. Now and then devastating new diseases would appear (often, as McNeill showed in *Plagues and Peoples*, as a result of conquests or the opening of new trade routes, both of which tended to bring formerly separated populations, and the germs they harbored, into contact). Initially the population would plunge and real wages would soar. As microbes and humans coevolved into a new equilibrium, population and pressure on resources would rise again, and the increasingly malnourished masses would become vulnerable to the next plague. All this is fascinating, but of questionable relevance to 21st century economic prospects.

The other great change is the invention of the business cycle. Economic instability has always been with us. But economic downturns before 1800 were the result of supply-side events like crop failures and wars. They bore little resemblance to modern recessions, which are the result of slumps in monetary demand. To have a recession as we understand it today, there must be a structure of paper credit erected on top of or in place of the circulation of gold and silver—otherwise, the credit contraction central to the phenomenon cannot get started. And a substantial part of the economy must also be likely to respond to slumping demand by cutting production rather than prices—otherwise a financial contraction will lead to deflation, but not to an actual decline in output. Preindustrial economies could not have recessions as we know them, both because of the simplicity of their monetary systems and because they consisted mostly of farmers, who respond to a drop in demand mainly by cutting prices rather than by growing less.

Economic historians generally think that the first true recession was the slump that hit England after the end of the Napoleonic Wars—in other words, the

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first recession occurred, as one would expect, in the first industrial nation. Nations that industrialized later also had to wait for their chance to share the recession experience. My colleague, the economic historian Peter Temin, tells me that the United States did not experience a true recession until the panic of 1873. Moreover, he has produced evidence that between 1820 and 1860 there was a clear difference in the behavior of the American and British economies: America was still a "classical" economy in which financial contractions might reduce prices but had little effect on growth, while England was already beginning to look recognizably Keynesian.

NEW ECONOMIES, NEW DIFFICULTIES

All that brings us to the reason people in the business community think that Fischer's book is relevant to current events, as well as to the reason for its actual irrelevance. Anyone who reads the business press knows that the mood these days is one of "what, me worry?" optimism. After six years of fairly steady growth with surprisingly quiescent inflation, every major newspaper and magazine has either suggested or flatly declared that the business cycle is dead—that the recession of 1990-91 was the last such slump we will see for many years to come.

Naysayers like me try to puncture this serenity by insisting that it ignores the lessons of history. It was not that long ago that George Bush got the boot because of the economy, stupid. We had a truly vicious recession in the early 1980s, and for that matter, Mexico, Japan, and even Canada (remember that country next to us?) can attest that the 1990s have by no means been always and everywhere as placid as the last few years in the United States. Moreover, we've been here before: near the end of another long recovery, in the late 1960s, pronouncements that the business cycle was dead were just as prevalent as they are today.

Why does the business cycle persist? Because, as the bumper stickers don't quite say, stuff happens: the world refuses to stay put, and policy is always playing catch-up. To look at the causes of booms and slumps since the business cycle was last declared dead is to be awed by the sheer variety of curve balls history throws at us. Who in 1969 imagined that a recession could be triggered by a war in the Middle East—let alone a fundamentalist revolution in Iran? Who would have thought that the ever-so-controlled Japanese economy could be whipsawed by a financial bubble that drove land and stock prices to ridiculous levels, then burst? Who could have predicted that two well-meaning projects—the political unification of Germany and the monetary unification of Europe—would interact to produce a disastrous slump? True, we learn from experience: the stock market crash of 1987 didn't play like that of 1929, because this time around Alan Greenspan, chairman of the Federal Reserve, knew what to do. But as fast as we learn to cope with old sources of boom and slump, new sources emerge.

Some people tell us that the forces that used to drive many recessions have abated: we are no longer as much of a manufacturing economy, inventories have become less of an "accelerator" of slumps, and so on. And they are surely right: we will not have the same problems in the future that we had in the past. We will have different problems.

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And because the problems are new, we will handle them badly, and the business cycle will endure.

But this is not a message business pundits want to hear, and for them Fischer's book is the perfect answer. Of course, they can now say, the business cycle has been with us for the last 150 years—but the long view tells us that while instability is the norm while you are passing through a price revolution, it is smooth sailing once you're through the crisis and reach the new "equilibrium." And guess what: we have just arrived at the Promised Land.

But the modern business cycle bears no more resemblance to the economic fluctuations that afflicted preindustrial Europe than NATO does to the Holy Roman Empire. It may be tempting to ignore the very real lessons of the last century because of some alleged parallels with the distant past. To do so, however, would be to use history not as a guide to the present, but merely as an excuse for some very ahistorical wishful thinking.

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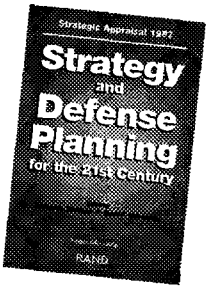

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Review Essay

How Close We Came

Steven Merritt Miner

"One Hell of a Gamble": Khrushchev, Castro, and Kennedy, 1958–1964. BY ALEKSANDR FURSENKO AND TIMOTHY NAFTALI. New York: W.W. Norton, 1997, 406 pp. $27.50.

In their excellent new history of the Kennedy-Khrushchev confrontation over Cuba, Aleksandr Fursenko and Timothy Naftali provide perhaps the most comprehensive narrative of the perilous moment yet to appear in print. It is also an exciting tale, reading at times like good spy fiction. The authors have used materials from every conceivable American and Soviet source, successfully integrating recent scholarship, interviews with key participants, and documents from the full range of Soviet departments and agencies, including KGB, GRU, and Politburo records previously unavailable. The only thing lacking is the Cuban piece of the puzzle, which must await a more open climate in Havana.

But while the book is clearly valuable and a major contribution to the field, it also reflects a somewhat disturbing trend. Fursenko, the chairman of the history department at the Russian Academy of Sciences, had exclusive access to many of the most important documents cited in the book. Although the authors' judgments seem sound enough, until other scholars are able to consult the same source materials, one must take it on faith that Fursenko's reading of the record is accurate and comprehensive and that the authorities did not feed him documents selected for political reasons. In any event, the current situation, with Moscow granting exclusive access to some Russian scholars while barring others, raises uncomfortable questions about state favoritism and the manipulation of historical truth.

REVELATIONS

Nevertheless, Fursenko and Naftali, a scholar at Yale University, have constructed a superb narrative, providing answers to some persistent questions. Among other revelations, the new Soviet materials demonstrate that Moscow's interest in the Cuban revolutionary movement

STEVEN MERRITT MINER is Professor of History at Ohio University.

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CORBIS-BETTMANN

First meeting: Castro and Khrushchev at the United Nations, 1960

began much earlier, and ran much deeper, than is commonly believed. Indeed, after the fall of Fulgencio Batista the Soviets were prepared to offer more military assistance to the Cubans than a cautious Fidel Castro, afraid of being seen as a Soviet puppet, was at first willing to accept. Even as Castro visited the United States in the spring of 1959, Moscow had already undertaken a covert program to arm Havana. Castro's brother, Raul, and Ernesto "Che" Guevara were committed communists who advocated an alliance with the Soviet Union from as early as 1957; they negotiated the military assistance. Fidel himself remains enigmatic. He undoubtedly took American hostility for granted, and each new American measure served only to confirm his worst suspicions about Washington's intentions. His real sympathies, however, remained unclear. In November 1960 he told Aleksandr Alexeev, the KGB *rezident* in Havana, "I have been a Marxist from my student days." But the Soviets did not entirely trust Castro; the new Soviet information reveals just how concerned Moscow was that he might opt for a heretical brand of communism like Mao's or even Albania's.

The authors also convincingly demonstrate that the world was much closer to nuclear war than was realized at the time or in the years since. In particular, the Soviet Union's provision of warheads for its "tactical" missiles in Cuba added a dangerous dimension to the crisis. Washington always believed that the missiles were armed with conventional warheads. Not only were the missiles armed with nuclear warheads, but Moscow came very close to granting authority to the Soviet commander in Cuba to use them at his discretion. Had President Kennedy cho-

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sen to invade the island, as a majority of his advisers at one point counseled, it could well have resulted in a nuclear attack on American warships, with incalculable consequences.

One of the study's more significant findings concerns the limitations of intelligence. The American government knew very little about decision-making in the Kremlin. But Soviet intelligence gathering also had its shortcomings. Despite the relatively open nature of American society, Moscow consistently misread signals from the United States, at times overestimating the threat of a U.S. invasion of Cuba, yet overlooking the preparations for the Bay of Pigs attack when it finally came. Perhaps even more surprising, both the Soviets and the Cubans failed to penetrate the Miami émigré community until after the Bay of Pigs. That, at least, is the authors' conclusion based on their study of Soviet documentation. The Cubans, however, may have known more than they were willing to share with their Soviet patrons.

While short, *"One Hell of a Gamble"* contains more meat than other glossier and less disciplined studies of the same era. Fursenko and Naftali restrict themselves to a terse narrative, only interrupting the flow for a few paragraphs of analysis at the end of each chapter. But their single-minded focus on recounting the course of events is in some ways unfortunate. They never pause to address some of the larger questions their study raises, including the effectiveness of deterrence in the nuclear era, the issue of great-power patronage for client states, the problems of superpower communication in an era of rapidly changing communications and weapons technology, and the complexities of the ideological motivations on both sides.

OF ONE MIND

This last omission is most regrettable. In public comments since the book's appearance, Naftali has argued that Soviet records from the period demonstrate that Marxist ideology—if defined as any rigid, preconceived program for action—played little role in Soviet decision-making. He argues that the upper echelons of the Soviet hierarchy were far more concerned with classical questions of power.

One might, however, draw very different conclusions from the book's evidence. Ideological sympathy, not simply the calculations of great-power rivalry, played a large role in the Kremlin's decision to support Castro. Anastas Mikoyan, the tough and wily survivor of the Stalin years and chairman of the Presidium from 1964-65, was charmed by Fidel at their first meeting, gushing, "Yes, he is a genuine revolutionary. Completely like us. I felt as though I had returned to my childhood!" The Soviet leaders were acutely aware of their relative weakness vis à vis the United States in strategic forces, yet Khrushchev decided to extend a nuclear guarantee to revolutionaries on a small Caribbean island half a world away, thereby imperiling the Soviet Union and creating a strategic liability it could scarcely defend against a determined American attack. Furthermore, although Soviet fears that Castro might be drawn into the Chinese orbit might be explained as traditional power concerns, how, other than in ideological terms, can one explain the fear of the heretical Albanians?

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One of the most interesting portions of the book recounts the conversations between Khrushchev and Castro when the latter visited the U.S.S.R. after the resolution of the missile crisis. The Soviet leader conducted what the authors evocatively describe as "a seminar on ruthlessness." A survivor of the hard school of Stalinism, Khrushchev cited Lenin's comment, "If it becomes necessary to use terror to achieve important political goals, then it must be employed energetically and with celerity." "One must always keep in mind," Khrushchev continued, "that at the very first moment of any antigovernmental activity, one must crush it quickly, decisively, not stopping in the event it becomes necessary to open fire." Not to be outdone, Castro boasted of his own mercilessness with domestic enemies of his regime. As a stilted translation reads, "My revolution has also not shrunk from serious decisive measures if dictated by necessity. The proof of this was the shooting of military and political criminals, the arrests of many saboteurs and intelligence agents of foreign powers." Such remarks might give pause to those who still view Castro as a romantic, misunderstood figure.

BOMBS AWAY

As for the results of the missile crisis, the authors provide fascinating insights. As is well known, the Americans secured the removal of the nuclear missiles from Cuba, much to the chagrin of Castro, who was excluded from the negotiations with Soviet officials as they reached a frenzy in October 1962. Although Washington insisted only on the withdrawal of the medium-range missiles, the Soviets also removed their tactical warheads—almost as an afterthought—for fear that American intelligence might discover them and reopen the Cuban wound.

In exchange for the removal of Soviet nuclear weapons, Kennedy pledged not to invade Cuba and agreed to remove American missiles from Turkey. One of the book's interesting revelations is Moscow's relative lack of concern about the missiles in Turkey: the Soviets did not even insist on their removal as part of an overall settlement. In fact, Moscow believed that Kennedy would never agree to link the two issues. The Turkish missiles only became an issue when Washington tipped its hand by admitting that it was prepared for such a deal. Kennedy's hired mythmakers immediately set to work covering up the blunder for fear it would anger America's Western European allies and harm the president's political standing.

In a postmortem to his colleagues in the Presidium, Khrushchev claimed victory. While acknowledging that "it would have been better not to have had to remove these missiles," he noted that the Americans had pledged not to invade Cuba, thereby ensuring that the Soviets would continue to have a foothold in the Western hemisphere: "So who suffered defeat? Who did not get what he wanted? We attained our goal; so they lost, we won." While Khrushchev's comments were no doubt self-serving, Castro's continuing reign suggests the Soviet leader was not entirely wrong.

Although Moscow gained a great deal from the American pledge not to invade Cuba, Khrushchev believed that those gains depended largely on Kennedy's personal word. This was, no doubt, in part because the Soviet premier understood how important leadership changes

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in the Kremlin were and believed the same dynamics prevailed in the United States. But Khrushchev also had a dismal view of American politics, which he believed to be a snake pit of contending cliques of generals and industrialists. His preconceptions were only reinforced by the ham-fisted diplomacy of the president's brother, Robert, who in a misguided attempt to pressure the Kremlin informed Moscow through back channels that only Kennedy himself could restrain the warmongers in the Pentagon from launching a nuclear attack on the Soviet Union.

GOLDEN BOYS?

Indeed, the Kennedy family's diplomacy as a whole does not emerge from this account looking very good. Following the assassination in Dallas, various representatives of the Kennedy clan did everything in their power to discredit Lyndon Johnson—"inexplicably," in the authors' words. Khrushchev was worried that Lee Harvey Oswald's communist connections might cause a rupture in Soviet-American relations. The Kennedy circle's attacks on Johnson only reinforced Moscow's "dark interpretation of the events in Texas." The KGB's analysis of the killing reads like an Oliver Stone script: it believed the assassination had been "organized by a circle of reactionary monopolists in league with pro-fascist groups of the United States with the objective of strengthening the reactionary and aggressive aspects of U.S. policy." These sinister forces had allegedly been alarmed by Kennedy's "various measures to normalize U.S.-Soviet relations, the broadening of civil rights of the Negro population, and also a significant limitation of the interests of part of the American bourgeoisie, above all the oil and metallurgical monopolies."

As this book and others based on new Soviet documents make clear, misconceptions about American intentions and the nature of American politics and society were the rule rather than the exception in the Kremlin. Given these habitual misunderstandings, it is almost miraculous that the two superpowers never blundered into a direct war. Although Fursenko and Naftali do not develop the argument, their work suggests that the terrifying power of nuclear weaponry, as well as the shared experiences of the horrors of World War II, caused leaders on both sides to back away from the brink. The Soviet-American rivalry had elements of stability that seem almost orderly when viewed through the prism of post-1991 international chaos. Nevertheless, as the events in the Caribbean remind us, that apparent stability could have disappeared with frightening speed with only a few unwise decisions.

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Recent Books on International Relations

Political and Legal

FRANCIS FUKUYAMA

Roots of Realism. EDITED BY BENJAMIN FRANKEL. Portland: Frank Cass, 1997, 421 pp. $45.00.

Realism: Restatements and Renewal. EDITED BY BENJAMIN FRANKEL. Portland: Frank Cass, 1997, 456 pp. $45.00 (paper, $20.00).

The realist theory of international relations has come in for some criticism in recent years. It is natural, then, that realists should seek a systematic reappraisal of their views. The first of these volumes provides an excellent overview of the development of realist theory, beginning with Thucydides and continuing through the Sophists, Machiavelli, and twentieth-century realists like Morganthau, Niebuhr, and Waltz. Paul Rahe's chapter is particularly acute, pointing out that contrary to common belief Thucydides did not seek to downplay moral issues in international politics.

The difficulties in turning realism into a scientific theory of politics are illustrated by the second volume, also intelligent. Restating realism to take account of contemporary realities means that the theory loses most of its elegant parsimony: as various chapters indicate, states now seek to maximize economic competitiveness rather than military power; domestic factors rather than the structure of the international system become determinants of whether states are aggressive or merely seek security; bipolarity is not clearly more stable than multipolarity. Rather than providing a comprehensive framework for understanding international relations, realism is one of several possible tools, better applicable in certain times and places than in others.

The Internal Management of United Nations Organizations: The Long Quest for Reform. BY YVES BEIGBEDER. New York: St. Martin's Press, 1997, 232 pp. $65.00.

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The overall tone of this book is defensive, and the author is clearly annoyed at repeated American charges of U.N. waste and mismanagement, as well as American "blackmail" in refusing to pay its dues arrears until serious internal reform occurs. Yet the book offers plenty of evidence that the various organizations of the U.N. system need dramatic overhaul. (Some facts I did not know: a permanent-five staff member in Geneva gets take-home pay of $313,200, but "only" $223,200 in New Delhi; the Trusteeship Council continues to exist despite the fact it has no trust territories.) The book offers relatively modest reform proposals and does not consider more radical forms of surgery that should be on the table such as the elimination of entire agencies.

Democracy and Race in Brazil, Britain, and the United States: Reaching for Higher Ground. WALTON L. BROWN. Lewiston: Edwin Mellen Press, 1997, 289 pp. $89.95.

The author correctly notes that the most difficult issue with which contemporary democracies have to deal is race. This book compares the ways in which the three democracies with the largest black minority populations have handled this problem. While the United States does not have a lot to be proud of in the way it has dealt with race over the years, the author's treatment of racial politics in the United States in recent years is superficial. The book fails to deal with the problem of the underclass and poverty. Brown does not take seriously the problems that policies to promote substantive equality through affirmative action and the promotion of group rights pose for the principles of individualism and limited government upon which liberal democracy is founded.

Requiem for Modern Politics: The Tragedy of the Enlightenment and the Challenge of the New Millennium. BY WILLIAM OPHULS. Boulder: Westview Press, 1997, 320 pp. $30.00.

A strange combination of left- and right-wing themes, this book attacks the tradition of the liberal Enlightenment both because modern life undermines community and virtue through trends like feminism and multiculturalism, and because it is bad for the environment. The root of both evils is modern capitalism. But as those who live in preindustrial societies know, being poor does not guarantee virtue, nor is it always more pleasant to be nature's victim than its master.

Economic, Social, and Environmental

RICHARD N. COOPER

The Big Ten: The Big Emerging Markets and How They Will Change Our Lives. BY JEFFREY E. GARTEN. New York: Basic Books, 1997, 256 pp. $24.00.

Drawing on his experience as undersecretary of commerce for international trade from 1993 to 1995, Garten attempts to justify the Clinton administration's emphasis on commercial diplomacy, while not dwelling on its serious mistakes. It is an exercise in what could be called constructive alarmism, a wake-up call about the changing international structure and opportunities. Its basic

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message is surely right: America's government and businesses should pay more attention to emerging markets, for that is where the economic action is likely to be in coming decades. Garten identifies ten countries as big emerging markets: Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Poland, South Africa, and Turkey.

Following Clinton, he lays heavy emphasis on the importance of jobs, fashionable political currency both in Europe and in the United States. But for the near future, the quantity and quality of employment will be determined by the overall performance of the domestic economy in its many dimensions, and only marginally by trade with emerging markets. Furthermore, exclusive or even predominant concentration on the big ten is likely to be misguided. A similar book written 30 years ago would have missed South Korea altogether; the Koreas of the future may not be among these ten countries. But that point does not blunt the thrust of Garten's message, only its focus.

NAFTA at Three: A Progress Report. BY SIDNEY WEINTRAUB. Washington: Center for Strategic and International Studies, 1997, 105 pp. $15.95 (paper).

Fortunately, if fortuitously, U.S. employment increased by five percent and U.S. output by eight percent during the first three years of NAFTA; some would almost certainly have blamed any decline in these figures on the accord, even though the Mexican economy is tiny compared to the U.S. economy. Indeed, U.S. exports to Mexico did decline during Mexico's economic depression of 1995. In this short book, Weintraub offers a fair-minded evaluation of NAFTA so far, attempting to sort out those events that can plausibly be attributed to NAFTA and those that occurred independently but had a bearing on Mexico's economic performance. He argues persuasively that NAFTA was not to blame for Mexico's financial crisis of 1994-95, nor the subsequent depression in output, employment, and imports from the United States. Indeed, despite the fall in U.S. exports in 1995, they remained above what they were in 1993, and Mexico did not impose import restrictions, as it had typically done during previous financial crises.

Bargaining with Japan: What American Pressure Can and Cannot Do. BY LEONARD J. SCHOPPA. New York: Columbia University Press, 1997, 406 pp. $49.50 (paper, $17.50).

Successive American administrations have felt both the need for and the frustration of pressing Japan into more open, liberal commercial policies. Political scientist Schoppa examines both the Structural Impediments Initiative of the Bush administration and the "framework" talks of the Clinton administration, each of which met with mixed success, with a view to sorting out the circumstances under which foreign pressure has succeeded or failed to alter Japanese trade policy or practices.

These negotiations went far beyond normal trade agendas to include domestic tax and land-use policy, retail trade and other regulatory law, as well as more

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traditional barriers to imports. Schoppa finds, unsurprisingly, that success is more likely when American proposals have domestic Japanese support, which is often not difficult to muster in a system as closed to innovation and new companies as the Japanese economy. When domestic allies are absent, they can sometimes be acquired with a plausible trade threat, but threats are likely to be less effective as the Japanese political system becomes more pluralistic and the new World Trade Organization provides a more legitimate, multilateral channel for redress.

The Multilateral Development Banks: Titans or Behemoths? BY ROY CULPEPER. Boulder: Lynne Rienner, 1997, 191 pp. $19.95 (paper).

A relatively specialized but useful book on an important group of financial institutions—the regional multilateral development banks. MDBs are attacked these days by both the political right, which claims they are unnecessary and even do damage by encouraging centralized planning, and the political left, which claims they favor indigenous elites and deepen poverty. Culpeper rejects both contentions. He believes the MDBs continue to play a useful, indeed necessary role in the world, but that their orientation and performance can be improved. More emphasis needs to be placed on the quality of loans, less on the quantity (and the related notion of resource transfer), and the focus should be on outputs, not inputs. That may well call for lower levels of lending, at least in the near future. He approves of the reorientation of most MDBs in the early 1990s toward reducing absolute poverty but argues practice can be brought into better alignment with the new principle. This is a thoughtful and informative book.

The Endangered Atmosphere: Preserving a Global Commons. BY MARVIN S. SOROOS. Columbia: University of South Carolina Press, 1997, 339 pp. $39.95 (paper, $19.95).

This book argues that the earth's atmosphere is a common property resource, like fisheries and medieval grazing land, which for millennia humankind has used—and recently abused—as a medium for waste disposal. Recognition of overuse has resulted in an international ban on nuclear tests in 1963, limitation on acidic pollutants in 1979, and limits on production of ozone-depleting chemicals in 1985-90. Pending are discussions on emissions of greenhouse gases, mainly methane and carbon dioxide, which are intimately related to agricultural production and the use of fossil fuels. Soroos offers a balanced, informative account of all these issues—how they rose to public and political attention, how the international community initially responded, how international agreements were finally put in place and with what effect—although he is too credulous of some of his sources on climate change. He rightly emphasizes the growing importance of international collaboration among scientists for both analysis and consensus-building, and raises but does not pursue questions about the capacity of the world community to set and enforce national quotas for greenhouse gas emissions.

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Military, Scientific, and Technological

ELIOT A. COHEN

Champions of Charity: War and the Rise of the Red Cross. BY JOHN F. HUTCHINSON. Boulder: Westview Press, 1996, 448 pp. $35.00 (paper, $21.00).

The Red Cross has acquired the status of an institution almost beyond reproach, save, perhaps, for those persistent critics who point to its silence about Nazi genocide in World War II. Hutchinson, however, a historian of public health, has no inhibitions about excoriating the Red Cross for serving as an auxiliary to armies rather than an opponent of human conflict. Serving to mobilize civilians in support of war, he contends, the Red Cross contributed to European militarism. Advances in abating the suffering of wounded soldiers during the nineteenth and twentieth centuries resulted from general advances in public health and the medical services of armies, not, as the Red Cross' propaganda suggests, the efforts of the organization's members. An exaggerated, curmudgeonly and cranky argument, no doubt, but one that nonetheless serves as a corrective to the standard history.

A Spy for All Seasons: My Life in the CIA. BY DUANE R. CLARRIDGE. New York: Scribner, 1997, 432 pp. $27.50.

One of the better spy memoirs in recent years, although the thoughtful reader should approach the genre with some caution. Clarridge's career in the CIA spanned the glory years of the Clandestine Services in that organization: from the mid-1950s until the late 1980s, when, like so many others, he was submerged under the tide of the Iran-Contra scandal. Clarridge was a dashing operator on the front lines of the Cold War. His ominous conclusion that the Clandestine Services "is finished as a really effective intelligence service" might be read as a bitter man's final taunt at those who repaid his courage and accomplishments with a special prosecutor's indictment. Alas, the recent and recurring scandals that have plagued American counterintelligence make one suspect that there is more to his severe conclusion than resentment.

Arming against Hitler: France and the Limits of Military Planning. BY EUGENIA C. KIESLING. Lawrence: University Press of Kansas, 1996, 260 pp. $35.00.

The fall of France in 1940 continues to fascinate students of warfare: how did a country rated to have the most powerful army in Europe crumble in a few weeks under the hammer blows of the Wehrmacht? Many able historians have tackled this subject, but few have done so with Kiesling's brio and shrewdness. Describing her scholarly strategy as one of "a blitzkrieg of archival firepower on certain narrow fronts," Kiesling has written a masterful account of how the French military deceived itself on a number of levels, from high-order military doctrine to mundane matters of training and equipment. The ease of movement among these levels of analysis, the depth of research, and the pungent clarity of

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the prose make this a book at once important and engrossing. All in all, a superb work that will find its place as one of the indispensable books on the subject.

Cultural Norms and National Security: Police and Military in Postwar Japan. BY PETER J. KATZENSTEIN. Ithaca: Cornell University Press, 1996, 307 pp. $35.00.

Katzenstein wishes, as the title suggests, to explore the relationship between culture and national security, using Japan as a case in point. He contends that, since World War II, Japan has developed a distinctive, comprehensive, and generally nonviolent definition of security that is different from that of the United States. To make his argument he follows a discussion of Japanese cultural norms with chapters on the police and the Japanese Self-Defense Forces, before exploring the U.S.-Japanese relationship and drawing an extended comparison between Japan and Germany. More conventional students of Japan will no doubt disapprove of a work by someone who has relied primarily on English-language materials and interviews. National security experts will find equally unsettling Katzenstein's unwillingness to appreciate Japanese national security doctrine as an outcome not of culture but of Japan's peculiar position as an American protectorate after World War II. Nonetheless, an intriguing work well worth reading.

The Powder Keg: An Intelligence Officer's Guide to Military Forces in the Middle East, 1996–2000. BY EDWARD B. ATKESON. Falls Church: Nova Publishers, 1996, 244 pp. $15.00 (paper).

U.S. Forces in the Middle East: Resources and Capabilities. BY ANTHONY H. CORDESMAN. Boulder: Westview Press, 1997, 145 pp. $62.00 (paper, $24.00).

During a long career in intelligence, retired Major General Atkeson closely studied the Middle East. His book is methodical and straightforward, concentrating on an analysis of the present and anticipated arsenals of Middle Eastern states, together with the potential sources of conflict among them. Cordesman's book is a similarly thorough look, heavy on tables and lists of facts and observations. Despite the drawbacks of inventory analysis, which usually does not penetrate into organizational culture and doctrine, these are valuable resources.

The Military and Conflict Between Cultures: Soldiers at the Interface. EDITED BY JAMES C. BRADFORD. College Station: Texas A & M University Press, 1997, 236 pp. $37.95.

The word "interface" does not belong in well-written text, let alone the title of a book, but that should not deter potential readers. Some of the United States' finest military historians—John Guilmartin, Dennis Showalter, Robert Utley, and Douglas Porch—have contributed essays to this book. Divided into sections of several essays each on premodern armies, Western forces and indigenous peoples, and twentieth-century clashes between colonial armies and the people they confronted, the book rewards a careful browsing. Without quite admitting it, the volume deals not with conflicts between cultures per se, but between what used to be regarded as advanced or developed civilizations and

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those that were not. That understood, the book has more coherence than most edited collections, and some of its individual essays are outstanding.

On-Site Inspections under the CFE Treaty. BY JOSEPH P. HARAHAN AND JOHN C. KUHN, III. Washington: On-Site Inspection Agency, U.S. Department of Defense, 1996, 369 pp.

The chances that this dense work will become a best-seller are nil. It is, however, a thoroughly documented account of the considerable bureaucratic labors required to administer the complex Treaty on Conventional Armed Forces in Europe, concluded in 1990 just as the Cold War was evaporating—and with it the rationale for the treaty. With great effort and ingenuity, American and European militaries have devised and operated a system for tracking deployments of weapons in Europe, a process that witnessed the removal of tens of thousands of pieces of Russian equipment to the east and the smashing, cutting, and crushing of much obsolete hardware on both sides. For those interested in the mechanics of conventional arms control, however, this will prove an interesting work, subject to the qualification that CFE monitoring took place under unusually favorable political conditions.

The United States

DAVID C. HENDRICKSON

We Now Know: Rethinking Cold War History. BY JOHN LEWIS GADDIS. New York: Oxford University Press, 1997, 425 pp. $30.00.

This brilliant study—Gaddis' fifth book on the Cold War—provides an exhaustive and ever-quizzical approach to the early years of the superpower conflict. Gaddis has a knack for asking large and interesting questions, and he brings a lively style to his answers. Despite the promise of startling revelations from newly opened archives, what "we now know" turns out to bear an uncanny resemblance to what we thought then; never has "post-revisionism" seemed so indistinguishable from the original orthodoxy. Much of that orthodoxy, as Gaddis insists, saw the issues at stake in Europe more clearly than the revisionists, appalled by Vietnam, later would. It was the tragedy of the postwar epoch, as the author would perhaps acknowledge, that the moral and strategic certainties persuasively reared in the pivot of the Soviet-American confrontation in Europe got pilloried and sundered in Southeast Asia. Gaddis discounts Kennan's warning: "The greatest danger that can befall us in coping with this problem of Soviet communism, is that we shall allow ourselves to become like those with whom we are coping." That danger, Gaddis insists, "never materialized." With this and other judgments one wishes to quarrel, even as one admires the author's ability to bring fresh curiosity and invigorating judgments to this tired old subject.

Dereliction of Duty: Johnson, McNamara, the Joint Chiefs of Staff, and the Lies that Led to Vietnam. BY H. R. MCMASTER. New York: HarperCollins, 1997, 464 pp. $27.50.

This angry book, by a former instructor

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at West Point, focuses on the escalation of the war in Vietnam from 1963 to 1965 and manages to indict just about everybody who was involved with that "bitch of a war." Lyndon Johnson's preoccupation with domestic concerns, Robert McNamara's arrogance and contempt for military experience, and the unwillingness of the "five silent men" on the Joint Chiefs of Staff to make clear to Congress and the American people the force levels that would be needed in Vietnam form the principal elements in the author's indictment. Though he insists that the deception of Congress and the public was at the root of the disaster, it seems likely that self-deception played a much greater role than he recognizes. "If only they had known the truth" is a more convincing lament than "if only they had told the truth."

American Diplomacy and the End of the Cold War: An Insider's Account of U.S. Policy in Europe, 1989–1992. BY ROBERT L. HUTCHINGS. Washington: Woodrow Wilson Center Press, 1997, 456 pp. $39.95.

This well-written study of the Bush administration's European policy gives a vivid account of the diplomatic strategies and processes that attended the liberation of Eastern Europe, the unification of Germany, and the collapse of the Soviet Union. The author, who was director of European affairs at the National Security Council in 1989-92, stresses that the outcome that had once seemed impossible was not, after all, foreordained. The principal American accomplishment—securing German unification within a Euro-Atlantic security framework—required a delicate juggling act that propitiated Germany, eased the fears of Britain and France, and reassured Soviet leaders. An important question raised by this grand settlement—though addressed only obliquely in this account—is whether current plans to expand NATO are consistent with the reassurances then given. Hutchings shows that the U.S. desire to bring Eastern Europe into Western institutions was present at the outset of the Bush administration, but also records as one of the "nine assurances" given to Soviet leaders in 1990 that no NATO forces would be deployed in the former GDR.

The United States and Europe after the Cold War. JOHN W. HOLMES. Columbia: University of South Carolina Press, 1997, 225 pp. $34.95.

The Alliance is dead! Long live the Alliance! Such, in effect, is the argument of this short and dyspeptic study of the transatlantic relationship since 1989. The author, a retired U.S. diplomat long concerned with European affairs, argues that the old military alliance is essentially moribund, and that a new and improved economic relationship ought to be built between the United States and European Union. The author is too pessimistic in forecasting an inevitable withdrawal of U.S. forces from the continent, and too optimistic in thinking that an improved economic relationship can form a plausible substitute for a political and security relationship, but the work provides a thoughtful guide to the various forms of Euro-American partnership that have been considered in the last several years.

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The Reluctant Sheriff: The United States after the Cold War. BY RICHARD N. HAASS. New York: Council on Foreign Relations Press, 1997, 156 pp. $24.95 (paper).

A clear and often cogent reconstruction of the proper lineaments of contemporary American grand strategy. Though one suspects that the "age of deregulation"—Haass' term for the post–Cold War era—will not catch on as the paradigm of the year, many of the dangers the author espies in the international environment do require consensual leadership by the United States. The principal merit of the book lies in its depiction of how and to what ends this leadership ought to be exercised. Haass rejects "hegemony" as well as isolationism, casts a skeptical eye on the expansion of the democratic alliance, and argues strongly against unilateralism in commercial policy. He is more of a unilateralist in security affairs, but even here insists rightly that unilateralism is in most instances "neither wise nor sustainable." Haass may underestimate the importance of standing institutions in legitimizing and supporting the attempts of the "reluctant sheriff" to organize "coalitions of the willing," but most persuasive is his insistence on conceiving American purposes in terms sufficiently enlarged that they may be shared and supported by a broad international consensus.

The World and Yugoslavia's Wars. BY RICHARD H. ULLMAN. New York: Council on Foreign Relations Press, 1996, 230 pp. $18.95 (paper).

"Toothless," "supine," "craven," and "spineless" are among the favored adjectives in this analysis of the world's response to the wars of Yugoslavia, a collection of eight essays that arose out of a Council on Foreign Relations study group. A measured introduction by Ullman and a lucid philosophical assessment of sovereignty and self-determination by Jean Manas give way to fire-breathing denunciations of Western diplomacy by most of the other contributors. The essays are of high quality but leave this reviewer dissatisfied. The threat and use of force were certainly necessary elements in the West's diplomacy, but employing force on behalf of achievable political aims was also crucial. The authors generally treat the idea of partition with the same derision they bestow on the fecklessness of the U.N. Protection Force. A more persuasive view is that partition ought to have formed a central part of diplomacy from the outset. Instead, unrealistic political objectives (the achievement of an independent, multicultural Bosnia) were paired, incongruously, with an apolitical humanitarianism that made hostages of peacekeepers.

Western Europe

STANLEY HOFFMANN

Threats to Democracy: The Radical Right in Italy after the War. BY FRANCO FERRARESI. Princeton: Princeton University Press, 1997, 311 pp. $35.00.

A political sociologist who has worked for a long time on the Italian radical right

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both as a scholar and as a consultant for a parliamentary investigation, Ferraresi, after giving up the academic attempt to find a clear and simple way of conceptualizing the far right, provides us with an invaluable survey of its many manifestations in post-1945 Italy—of its ideologies and myths, of its tactics, attempted coups, and acts of terrorism. What he has unearthed is often terrifying. His study of what he calls the "strategy of tension"—a strategy that entailed criminal acts about which evidence is often weak and "none of which have been adjudicated"—is particularly revealing. But he does not deal in any detail with the "conversion" of the Italian Social Movement, led by Gianfranco Fini, to democracy, and with the chances of the far right in the post-scandal (and post-Christian Democratic hegemony) phase of Italian politics. What is particularly disturbing is his conviction that "hidden actors," such as domestic and foreign intelligence, were more deeply involved in these activities than he had previously thought, and his conclusion that "a powerful irrationalistic wind" is blowing in much of Europe.

New Britain: My Vision of a Young Country. BY TONY BLAIR. Boulder: Westview Press, 1997, 338 pp. $22.00.

As campaign manifestoes go, this is certainly an illuminating one. A collection of speeches and articles, it affords a good view of the "new Labor" that Blair has shaped and of the "new Britain" he will now try to create as prime minister. His vision is far less vapid than his prudent and rhetorically hollow campaign made one fear. What emerges is, indeed, something new (for the Labor party): a vision of class cooperation instead of class struggle; an emphasis on efficiency and technological progress at least as strong as the more traditional emphasis on social justice; a genuine, informed concern for education (it will be "the passion of my Government"); a recognition of the need for a market economy but not for the demise of public means of intervention; a far more positive attitude toward Europe than in the past; and a devolution of power to Britain's components, putting an end to "the era of big centralized government." The notion of a "stakeholder" economy and politics emphasizing investment, quality, and trust was, if not a triumph of substance over slogans, a good way of stealing Conservative assets.

Hope and Glory: Britain 1900–1990. BY PETER CLARKE. New York: Allen Lane, 1997, 454 pp. $29.95.

A historian from Cambridge, Clarke has written a fine history of twentieth-century Britain that focuses on economic and social developments more than political and parliamentary affairs. It gives a fair presentation of major issues, controversial questions, and the author's own point of view. He is far less apocalyptic about Britain's decline than many other writers, and emphasizes the degree to which Britain's postwar story is not so bleak: Britain's economy "enjoyed secular growth unprecedented in its history" from 1945 to 1990. But he notes that France and Germany "bounced back from the setback of the Second World War more effectively than the only combatant European country to remain unconquered throughout." Also on the negative side, Clarke finds that "Thatcher achieved her victories at a terrible cost, usually borne by others" and relied more on "improvisation than

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she liked to think." He concludes that the "most obvious missed opportunity" was Britain's failure to join the Common Market early on.

Gladstone: A Biography. BY ROY JENKINS. New York: Random House, 1997, 698 pp. $35.00.

This wonderfully readable volume gives us a brilliant account of the politics of nineteenth-century England, and of the weight of the "Irish question" in particular. But Jenkins, a former statesman, also writes with a novelist's gifts. What is, therefore, particularly admirable is the re-creation of character, the psychological insights into the motivations and complexities of a formidable, tormented, "most remarkable specimen of humanity." Gladstone was a man whose energy—physical as well as intellectual—was awesome, a voracious and erudite reader, a great orator, and a man who claimed that "religion was more important to him than politics." Between 1845 and 1851 (from his 36th to his 42nd year) Gladstone "experienced four religio-sexual emotional crises" in which "temptation and guilt in combination indisputably produced high states of neurotic tension." Gladstone's wife once exclaimed: "Oh, William dear, if you weren't such a great man you would be a terrible bore." With his extreme sensitivity and frequent self-righteousness, he must indeed have been more than a little hard to take. But the sprightly, smooth style of Jenkins removes any possibility of boredom. In an age of enormous biographies, many of which tend to be "pathographies," this study manages to seem short, and does full justice to its eminent subject.

Western Hemisphere

KENNETH MAXWELL

A Culture of Collusion: An Inside Look at the Mexican Press. EDITED BY WILLIAM A. ORME, JR. Miami: North-South Center Press, University of Miami, 1997, 159 pp. $16.95 (paper).

A timely and valuable book on a long-taboo topic on the U.S.-Mexico horizon: the complex relationship between the ostensibly independent Mexican news media and the governing party. This well-documented study claims the relationship is often sustained by subsidies, bribery, fear, and, on occasion, murder. The result of a two-year investigative project by the New York-based Committee to Protect Journalists, headed by Orme, this pioneering report reveals a pattern of violence against journalists outside the capital and includes brief histories of 11 Mexican reporters who were killed in mysterious circumstances over the past 10 years. A chapter by Marjorie Miller and Juanita Darling, both formerly with *The Los Angeles Times,* Mexico City bureau, also explores the financial and political interests of Emilio Azcarraga's Televisa empire and the growing Mexican influence on Spanish-language news broadcasting in the United States. Under the North American Free Trade Agreement, Orme says, there is no "level playing field." U.S. law permits

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Mexican companies to control U.S. cable networks and news programming, but NAFTA allows no more than 49 percent U.S. ownership in Mexican cable television networks. The independence of the press in the July 1997 legislative contest, Orme believes, will be the best test yet of past reforms and President Zedillo's commitment to democracy and an open society, since the party bosses can be expected to use all the traditional levers of coercion and co-optation at their disposal.

Implausible Deniability: State Responsibility for Rural Violence in Mexico. New York: Human Rights Watch, 1997, 95 pp. $10.00 (paper).

A detailed and at times harrowing examination of the Mexican government's role in and responsibility for rural violence. Even where private citizens are involved in assassinations, abductions, threats, and expulsions, government officials have facilitated abusive acts, failed to prosecute, and used the judicial system for partisan ends. Looking in particular at Chiapas, Guerrero, Oaxaca, and Sinaloa, this report reveals an ugly social reality that has been largely ignored as Mexico has struggled with political, economic, and legal reforms, and it castigates the Zedillo administration for its neglect. This powerful indictment argues that the protection of human rights must be placed on the Mexican government's reform agenda, and nowhere more so than in the rural areas. Conflicts over religious and political differences, counterinsurgency, and disputes over land and other community resources have provoked widespread human rights violations, with both the Catholic Church as well as Pentecostals subjected to vicious assault, especially in Chiapas.

Police Brutality in Urban Brazil. New York: Human Rights Watch, 1997, 118 pp. $10.00 (paper).

Rapid urban population growth, soaring crime rates, and public dissatisfaction with the criminal justice system have led the Brazilian public to acquiescence in violent extrajudicial measures against criminals such as police violence and death squads. But earlier this year, a brutal police shakedown in São Paulo was captured on videotape in a manner reminiscent of the 1991 beating of Rodney King in Los Angeles and likewise repeatedly played on the evening television news. Extensively documented and focusing on seven of Brazil's cities, this report reveals that police often kill without justification, frequently file false reports describing extrajudicial executions as shootouts, and remove the bodies from the scene of the crime. This report, however, does point to positive changes, especially on the critical matter of police impunity. In particular, it points to President Cardoso's 1996 National Plan for Human Rights that resulted from a collaborative effort of the Ministry of Justice, nongovernmental organizations, and human rights advocates, and notes encouraging efforts to address the problem of police violence in Belo Horizonte, Minas Gerais, and Pernambuco state.

Technopols: Freeing Politics and Markets in Latin America in the 1990s. EDITED BY JORGE I. DOMÍNGUEZ. University Park: Penn State Press, 1997, 287 pp. $55.00 (paper, $18.95).

This interesting book contains five informative essays on the careers, ideas, and policies of the Latin American "technopols." The term was coined, as Richard E. Feinberg tells us in his foreword, by Jorge

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Domínguez and himself over margaritas at the Adams Morgan Hotel in Washington to describe a new type of Latin American leader. The "technopol" is part technocrat, to be sure, but just as important, a political actor who understands that democratic politics can best shape and assure long-term economic development and that markets are in turn good for democracy. They examine Domingo Cavallo in Argentina, Pedro Aspe in Mexico, Fernando Henrique Cardoso in Brazil, and Evelyn Matthei and Alexandro Foxley in Chile. All are major social scientists, and all but Matthei served as finance ministers of their countries, with Cardoso also elected president. Unfortunately, as with much of Latin American social science, this book's frame of reference remains parochial, and little attention is paid to the global changes and ideological transformations that have significantly shifted the discourse on politics and economics over the past decade and deeply influenced men like Foxley and Cardoso.

Constructing Democratic Governance: Latin America and the Caribbean in the 1990s—Themes and Issues. EDITED BY JORGE I. DOMÍNGUEZ AND ABRAHAM F. LOWENTHAL. Baltimore: Johns Hopkins University Press, 1996, 128 pp. $13.95 (paper).
Constructing Democratic Governance: Mexico, Central America, and the Caribbean in the 1990s. 232 pp. $15.95 (paper).
Constructing Democratic Governance: South America in the 1990s. 224 pp. $15.95 (paper).

This comprehensive three-volume set takes a close look at the status of democratic regimes in Latin America and the Caribbean. In terms of electoral politics, the picture is encouraging. But beyond the achievement of free and competitive elections, there are major enduring problems. In strengthening the role of legislatures and the judiciary, redressing social inequities, protecting human rights, and establishing civilian control over the military, Latin America lags far behind the industrialized democracies. Essays by Alan Angel on incorporating the left into democratic politics and Deborah J. Yashar on indigenous protest and democracy are backed up by detailed case studies of virtually every country in the region, including a chapter by Marifeli Perez-Stable on the slender prospects for democracy in Cuba. Each volume shares a brief introductory statement by the editors and concluding chapter by Domínguez and Jeanne Kinney Giraldo, with index and endnotes, so that each can stand on its own. Overall this is a remarkable collaborative achievement and provides a quick, authoritative, and handy reference that will be invaluable to students.

Eastern Europe and Former Soviet Republics

ROBERT LEGVOLD

The Russian Empire and the World, 1700-1917: The Geopolitics of Expansion and Containment. BY JOHN P. LEDONNE.

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New York: Oxford University Press, 1997, 394 pp. $45.00 (paper, $22.95).

LeDonne has filled an important deficit. Until this book, there had been no major account in English of Russian foreign policy from Peter the Great to Lenin. Ledonne orders this large expanse of history by tracing the outward movement of Russia against neighboring empires and their equally regular maneuverings to keep it hemmed in. He takes his inspiration from the nineteenth-century geopoliticians Sir Halford Mackinder and Admiral Alfred T. Mahan, using their ideas to capture the permanent ebb and flow between the heartland and the coastlands. Geography is destiny in this account. That allows LeDonne to reduce the history of Russian foreign policy to a neat, striking pattern of expansion and containment. But in doing so, contrary to the historian's craft, he blots out the complicated and often unique interplay of domestic and international factors that caused Russia to act the way it did.

My Years with Gorbachev and Shevardnadze: The Memoir of a Soviet Interpreter. BY PAVEL PALAZCHENKO. University Park: Penn State Press, 1997, 394 pp. $35.00.

Translating History: The Top Russian Interpreter's Twenty-Five Years on the Front Line of Diplomacy. BY IGOR KORCHILOV. New York: Scribner, 1997, 400 pp. $27.50.

By now almost all those connected with the Gorbachev era have published their memoirs, including Gorbachev himself. Add to these now the retellings of his interpreters. Palazchenko became Gorbachev's primary interpreter in English; Korchilov backed him up and served as Shevardnadze's principal interpreter. Together they offer further crosschecks on the accounts we already have of the many meetings Reagan, Shultz, Bush, and Baker held with their Soviet counterparts. Beyond this they add conversations at formal dinners and luncheons, in automobiles, and on daises. Both men are reflective about their former bosses, taking the scene in critically but with sympathy and perceptiveness. Korchilov conveys well the human qualities of both men. Of the two, however, Palazchenko provides the meatier account of the substantive issues in U.S.-Soviet relations. Doubtless this is in large part because he eventually became a part of the U.S. and Canada section of the foreign ministry and worked on the substantive arms controls issues so prominent in the negotiations.

Ideas and International Political Change: Soviet/Russian Behavior and the End of the Cold War. BY JEFFREY T. CHECKEL. New Haven: Yale University Press, 1997, 191 pp. $26.00.

In the mid-1980s Checkel was among the first to recognize the significance of Gorbachev's "new thinking" in foreign policy. Thus, not surprisingly, he assigns a leading role to ideas in his reconstruction of the end of the Cold War. Ideas do not work alone; the basic political setup has to favor their triumph; leaders who embrace them have to be able to impose them; and a country has to find itself in big enough trouble to want to impose them. Checkel explains how these elements came together in the Gorbachev era, producing great change, and, in contrast, the reasons they did not during the earlier Nixon-Brezhnev détente. In a nutshell, although breakthrough thinking already existed in

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their day, Brezhnev and company hesitated to embrace it because the need for change eluded them. In the process, the author richly paints the conceptual revolution over which Gorbachev presided. However, when he tries to use the same framework to explain what has gone wrong in the years since, why ideas are no longer so powerful, coherent, or edifying in the Yeltsin period, he comes up short.

Varieties of Transition: The East European and East German Experience. BY CLAUS OFFE. Cambridge: MIT Press, 1997, 249 pp. $18.00 (paper).

In the substrata of Offe's book two large issues weave in and out. First is whether the forms of thought by which analysts normally deal with political change measure up to the scale of Eastern Europe's transformation. To the extent that established concepts are dwarfed by a wholesale recasting of both state and economy, he answers no. He struggles with what it means for one of these spheres to have three processes under way at once—nation-building, state formation, and deciding who gets what, when, and how. The East German case drives his analysis, but he insists on the importance of differences in the ways East European states have experienced these transitions. The second large issue involves the relevance and adequacy of the Western model for these societies. Because the author believes the political and economic architecture of Germany or the United States inheres as much in their traditions, cultural patterns, and states of mind as in formal institutions, he sees their relevance as limited. And because he is aware of the pathologies in these models—principally their failure to solve the problem of social justice—he doubts their adequacy. At this level the analysis is more a sketch than a rigorous argument. Stimulating as this sketch is, in some of its more challenging places a clumsy translation from the German makes the text less than a treat to read.

Keystone in the Arch: Ukraine and the Emerging Security Environment of Central and Eastern Europe. BY SHERMAN W. GARNETT. Washington: Carnegie Endowment for International Peace, 1997, 141 pp. $14.95 (paper).

Precious few books or articles do justice to both the core challenges facing Ukrainian foreign policy and the reasons Ukraine's success or failure in meeting them matters to the rest of Europe. Garnett's book does. He brings balance and subtlety to the core issue—Ukraine's relationship with Russia—treating specific conflicts in detail, but only after laying out the deeper and more basic factors at work. Rather than end at that, he goes on to explore Ukraine's relations with its remaining neighbors and to show in what fashion Ukraine will, amid this larger mosaic and despite the studied underestimation of the West, figure in the well-being and safety of the rest of the continent.

The Political Economy of Dual Transformations: Market Reform and Democratization in Hungary. BY DAVID L. BARTLETT. Ann Arbor: University of Michigan Press, 1997, 299 pp. $39.50.

Bartlett argues that the process of build-

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ing democracy in failed socialist societies need not jeopardize the other equally prized aspiration of turning these encrusted socialist monstrosities into modern market-oriented economies. Bartlett situates himself among the fashionable theories contending that institutions, understood broadly enough, are not simply vessels or residues but creative forces. He shows how the emerging infrastructure of democracy in Hungary has eased the path of economic reform by defending state agencies against the importuning of aggrieved special interests and by forcing the "losers" of reform to pursue their case in a basically uncongenial electoral arena.

His case study of Hungary after the fall of communism, matched by an equally elaborate exploration of political-economic failure in the ten years before, counters what he takes to be conventional wisdom: alas, say many, democracy, which is essential in legitimizing the new economic order, lets those who will pay its price obstruct its construction. While a thought-provoking rejoinder to those who draw the lesson that the East Asian model of reform through authoritarianism works better, Bartlett's argument fails to explain why the synergy between democracy-building and economic reform has been so much less productive in the states south and east of Hungary.

Middle East

WILLIAM B. QUANDT

Rubber Bullets: Power and Conscience in Modern Israel. BY YARON EZRAHI. New York: Farrar, Straus, and Giroux, 1997, 308 pp. $25.00.

The title of this stimulating intellectual essay is meant to evoke Israelis' ambivalence about their current struggle with the Palestinians. If they were engaged in a war of survival, they would not hesitate to use real bullets to defend themselves; if they were acting as police officers to maintain order within their own borders, bullets would be excessive. The compromise, in reality, has been to use rubber-coated steel bullets against Palestinian stone-throwers, intended to wound although sometimes lethal. The broader point that Ezrahi is trying to make is that Israel is a society torn between two impulses, the old communal, pre-state vision of collective sacrifice and struggle, embodied in the myth of the Kibbutz, and a more recent emphasis on individualism, free thinking, resistance to group conformity, and readiness to compromise for the sake of peace. The communal ethic extols military service and discourages questioning the policies and purposes of the state. The individualistic ethic insists that it is proper and moral to question policies such as the Israeli occupation and the use of force against Palestinian youth during the intifada, and indeed many of the founding myths of the state. Ezrahi is squarely in the individualist-peace camp, but this book is much more than a personal manifesto. He reflects at length on the limits of both visions but concludes that Israelis increasingly need to respect individualistic, nonconformist strands in their culture as they become a modern, prosperous society. At a time when many Americans are urging a return to communitarian values, this is a revealing affirmation of the virtues of individualism from one who has seen

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the darker side of communal norms. At times repetitious, the book is nonetheless thought-provoking from beginning to end.

Economic Policy Reform in Egypt. BY ILIYA HARIK. Gainesville: University Press of Florida, 1997, 344 pp. $49.95.

Harik has been studying the Egyptian economy with a political scientist's eye for much of the past 30 years. This book is a major interpretation of the choices made in the Nasser era to design a managed economy to promote order and balance, and only secondarily to foster growth. Harik argues that it is a mistake to see in the Nasser model a clear preference for urban workers over rural peasants—the so-called urban bias model—because the regime was seeking to appease both. He describes a regime more concerned about jobs than profits, simultaneously extracting wealth from the population by means of low wages and providing subsidies to keep food prices, energy, and housing inexpensive. This all makes a certain kind of sense. But it had disastrous economic consequences. Beginning in the 1980s, Egyptian leaders knew that serious reforms were needed, but they feared the political and social consequences of embracing the free-market model. Egypt has finally begun to carry out serious reforms—Harik dates them to about 1990—and has recently been added to a major index of emerging markets; in addition, the stock market has been rapidly rising. Harik concludes with thoughts on the proper role of the state as mediator with the private sector. All in all, a very impressive book.

Egypt's Road to Jerusalem: A Diplomat's Story of the Struggle for Peace in the Middle East. BY BOUTROS BOUTROS-GHALI. New York: Random House, 1997, 384 pp. $25.00.

As Minister of State for Foreign Affairs, Boutros-Ghali was part of the circle of advisers that accompanied Anwar Sadat to Jerusalem and then on to Camp David and the 1979 peace treaty with Israel. During those years Boutros-Ghali kept a daily diary, from which this book is largely drawn. As such, it does not purport to be a complete history, but rather the perspective of one who was close to the key players but rarely a decision-maker in his own right. One of the many pleasures of the book is the finely drawn portraits of the diverse characters who participated in the peace talks, including Menachem Begin and Moshe Dayan on the Israeli side, and, most importantly, Sadat himself. There are few big surprises in this story, but the inner workings of the Egyptian team are discreetly shown, often through the eyes of a frustrated Boutros-Ghali who was not privy to all of Sadat's thinking. Apart from the main theme, there are marvelous portraits of several African leaders whom the Egyptian diplomat tried to convince to support Camp David. This fine book ends with a moving account of Boutros-Ghali learning of Sadat's assassination—the same fate that his own grandfather met and to whom he dedicates the volume.

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Parliamentary Politics in Revolutionary Iran: The Institutionalization of Factional Politics. BY BAHMAN BAKTIARI. Gainesville: University Press of Florida, 1996, 282 pp. $49.95.

As a self-styled anti-Western Islamic Republic, Iran has often been surprising in its adoption of Western political institutions, particularly its parliament. This detailed study of the Iranian *majlis* convincingly shows that competitive politics does take place in Iran, that real debates occur in the parliament, and that much can be learned about contemporary Iran by looking at this institution. Baktiari has interviewed many of the deputies and has read much of the primary material. It needs to be stressed, of course, that the Council of Guardians, a body of 12 Islamic jurors, has the right to exclude candidates from parliamentary elections on any grounds and has used this power quite widely. So one cannot speak of democracy at work, but there is nonetheless more political pluralism in evidence in Iran today than in many other Middle East countries. Long on empirical evidence, the book is less satisfying when it comes to broader themes and theory. Still, it is a unique study of a unique institution.

Building a Palestinian State: The Incomplete Revolution. BY GLENN E. ROBINSON. Bloomington: Indiana University Press, 1997, 228 pp. $29.95 (paper, $14.95).

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Robinson's most controversial assertion is that the PLO used the Oslo accords to win a lease on life just as the intifada was about to make it irrelevant. Returning to Gaza, Arafat proceeded to restore the old families to their traditional positions, while quashing the new social and political groups. As a result, Robinson believes, a future Palestine will likely be authoritarian. This may well be true, and many Palestinians have expressed these same fears. But the sharp contrast between insiders and outsiders, between notables and young revolutionaries, is too sharply drawn. In the small confines of Palestinian society, everyone on the outside has relatives on the inside, notables have links to non-notables, and even Arafat has had to make some room for new blood in the ruling circles. If he does finally succeed in establishing a Palestinian state—and there are still many reasons to be skeptical—then many of the social forces unleashed by the intifada, including the Islamist opposition to the PLO, may have a chance to reassert themselves. If he or his successors fail, Palestinians will be left in Bantustans and the issue of democracy will seem quite remote.

The Politics of Jerusalem Since 1967. BY MICHAEL DUMPER. New York: Columbia University Press, 1997, 365 pp. $34.00.

This book, while written from a perspective that assumes that both Israeli and Palestinian interests in Jerusalem will eventually have to be addressed in any lasting settlement, is largely devoid of propaganda. Instead, one finds carefully documented information on the demography of the city, maps that show the changes over time, and a catalog of issues that have to be addressed on a daily basis. A reader will learn to suspect the grandiose claims of partisans. For example, the frequent Israeli assertion that Jerusalem has always had a Jewish majority depends on how one defines the city. Even now, there is no agreed definition of what constitutes Jerusalem. Within the confines of the present-day municipality, Israelis make up about two-thirds of the population, but the contiguous metropolitan area just beyond the boundaries of the city is predominantly Arab. Reading this book will help to explain why the dispute over building additional homes for Jews on one of the remaining empty spaces in Jerusalem evokes such strong emotions.

Rethinking Tradition in Modern Islamic Thought. BY DANIEL BROWN. New York: Cambridge University Press, 1996, 185 pp. $49.95.

This slim volume takes aim at one version of the debate among Muslims and makes a clear hit. The author argues that it is wrong to think in the terms of conservatives who cling to tradition and modernizers who rely on reason. The *sunna,* or traditions based on the life of Mohammed, are used by both proponents of orthodoxy and those who seek to change the old ways. Like most great traditions, that of Islam contains within it plenty for both schools to draw on. One of the most interesting accounts in this balanced study is the failure of those who sought to narrow drastically the scope of the *sunna.* Instead, the "revivalists" have won the debate and use the traditions to support their often radical agenda. Islamist move-

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ments in Egypt and Pakistan provide the empirical base for the study.

Asia and the Pacific

DONALD ZAGORIA

The Great Wall and the Empty Fortress: China's Search for Security. BY ANDREW J. NATHAN AND ROBERT S. ROSS. New York: W. W. Norton, 1997, 288 pp. $29.95.

This volume argues that in its ability to project power, China remains by far the weakest of the four great powers in Asia. Also, the PRC's security remains hostage to the behavior of potential adversaries and unreliable neighbors, such as the two Koreas and Vietnam. These considerations give China a strong stake in maintaining regional stability and developing cooperative relations with its great power rivals. The book concludes with three recommendations. First, America needs to maintain current deployments in Asia in order to prevent destabilizing changes in the regional balance of power. Second, China's integration into the international order requires an effective management of conflicts of interest. Third, China should be brought into a variety of multilateral institutions. Its final words are worth repeating: Western policymakers can accommodate China when they should, persuade China when they can, and resist China when they must. The book should be widely used in courses on international relations, American foreign policy, and Asian security.

Living with China: U.S.-China Relations in the Twenty-First Century. EDITED BY EZRA F. VOGEL. New York: W. W. Norton, 1997, 352 pp. $25.00.

If there is one indispensable insight that appears throughout the volume, it is that, although the challenges posed by China are great, the United States' opportunity to gain Chinese cooperation on a number of important issues is equally great. As Douglas H. Paal, former special assistant to President Bush, puts it: "China will likely be at most a source of 'problems' for America, not a 'threat.' And problems can be fixed." Or, as the final report puts it: "Some Americans believe that China's policies across the board run counter to U.S. interests and that efforts to moderate Chinese behavior by cooperation will be unproductive. This Assembly rejects this view . . ." As Paal and others point out, historical perspective supports this optimism. For example, China is now an active trade and economic partner, and it has long since ceased aiding pro-Chinese insurgencies in Southeast Asia. Many Chinese would argue that the last two decades have seen marked progress in their promotion of human rights. China has joined many international organizations and conventions, has exercised only two vetoes in the Security Council since 1972, and has ratified the Nuclear Nonproliferation Treaty. If you want a convincing response to Bernstein's and Munro's *The Coming Conflict with China,* you need look no further.

A New U.S. Policy toward India and Pakistan. CHAIRED BY RICHARD N. HAASS. New York: Council on Foreign Relations, 1997, 81 pp. $5.00 (paper).

An independent task force of the Council on Foreign Relations urges that instead

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of trying to roll back India's and Pakistan's de facto nuclear capabilities, the United States discourage nuclear testing and deployment and the export of related technologies. With India, it urges a closer strategic relationship. With Pakistan, Congress should allow limited conventional arms sales and military assistance to fund education and training programs, untie economic assistance programs from nuclear developments, and repeal prohibitions against loans that facilitate U.S. business activity. Moreover, at the Pentagon, National Security Council, and CIA, South Asian issues are treated intermittently and secondarily by the relevant regional bureaus while attracting constant attention from nonproliferation experts, contributing to the dominance of their concerns. The panel recommends that the U.S. military treat both countries as part of the Pacific Command, and that the National Security Council have at least one full-time person assigned to South Asia.

The Crisis in Kashmir: Portents of War, Hopes of Peace. BY SUMIT GANGULY. New York: Cambridge University Press, 1997, 182 pp. $49.95.

This volume represents social science at its best. It is a detailed case study of the Kashmiri insurgency, in which India has deployed 400,000 troops, 15,000 people have died, and 200,000 have become refugees. The book is based on extensive interviews with government officials, Kashmiri activists, journalists, and military personnel—all against the background of an interesting theory as to why a full-blown popular insurgency emerged when it did. Ganguly's central argument is that the timing of the insurgency can be explained by the linked processes of political mobilization and institutional decay. In an attempt to woo the citizens of Kashmir, the national government in New Delhi dramatically helped expand literacy, mass media, and higher education, which produced a generation of politically sophisticated Kashmiris. At the same time, however, the national government, fearful of secessionism, also stultified the development of Kashmiri political institutions. The volume concludes with some sensible recommendations for moving toward a resolution of the crisis.

The Dynamics of Foreign-Policy Decisionmaking in China. BY LU NING. Boulder: Westview Press, 1997, 218 pp. $75.00.

This pathbreaking volume, written by a former career Chinese foreign service officer who now lives and works in Singapore, is the best book published to date on the process of foreign policy–making in China. Based on a wealth of Chinese and Western data, personal experience, and interviews, the volume provides fascinating and important details on, for example, the Chinese decision to intervene in the Korean War and on the Chinese rapprochement with the United States in the early 1970s. There is a brief but trenchant analysis of the change in foreign policy decision-making after Deng Xiaoping took power in 1978 and the shift in focus on the part of the central leadership from the nation's physical security (which no longer seems to be

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threatened) to its economic development. The author also analyzes the erosion of the preponderant role of the paramount leader and the emergence of a more collectivized decision-making process with checks and balances, which leads to greater authority for both the foreign affairs establishment and for other bureaucracies, at the expense of the Ministry of Foreign Affairs. The Chinese military, says the author, has not become an independent force in foreign policy decision-making, but instead remains firmly under the control of established guidelines formulated by the civilian central leadership.

Africa

GAIL M. GERHART

African Women: A Modern History. BY CATHERINE COQUERY-VIDROVITCH. Boulder: Westview Press, 1997, 308 pp. $69.95 (paper, $24.95).

Women's history in Africa is a very new object of study and suffers from a scarcity of reliable and impartial source materials. Add to these difficulties the immense cultural and environmental diversity of the continent and its complex variation of colonial experiences, and it is not surprizing that this pathbreaking effort at synthesis comes off as patchy. After looking for broad patterns in precolonial gender roles and attitudes, the author, a prominent French historian, traces changes in women's lives resulting from urbanization, the introduction of cash crops, the spread of formal schooling and Christian mores, and the mutually reinforcing African and European notions of female dependence prevailing in the colonial era. Significant advances in women's status and collective consciousness, the author asserts, date only from the early 1980s. Policymakers hoping to find practical recommendations about women's role in development may be disappointed. Analytic depth is traded for breadth backed up by anecdotal evidence that oscillates between the subtle and the slapdash. Nevertheless, as an introductory work in a growing academic field, this welcome book fills a conspicuous gap in African studies.

White Man's Justice: South African Political Trials in the Black Consciousness Era. BY MICHAEL LOBBAN. New York: Oxford University Press, 1996, 288 pp. $65.00.

Politics By Other Means: Law in the Struggle Against Apartheid, 1980–1994. BY RICHARD ABEL. New York: Routledge, 1995, 644 pp. $79.95 (paper, $21.95).

These two excellent and complementary works by legal academics use multiple case studies to explore the ways South Africa's legal system both constrained and reinforced the state's power to suppress popular resistance before 1994. In the final years of the apartheid era, the system drew increasing attention from human rights specialists fascinated by the relationship between law and politics in undemocratic societies. Were South Africa's courts—West European in inspiration and praised by many as fair—a bulwark of the system, or its potential Achilles' heel? A politically supreme white-controlled parliament made the laws, and an all-white judiciary applied them; traditions of common law were

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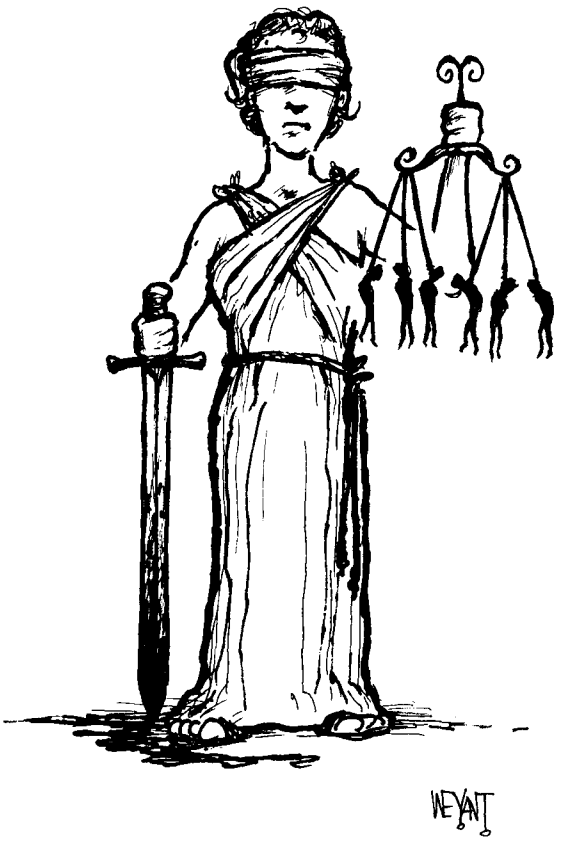

strong, but the constitution contained no bill of rights, and courts lacked powers of judicial review. As black opposition intensified, the system increasingly became a paradox of overt legalism and covert illegality including torture, assassinations, and state-sponsored vigilantism.

Lobban focuses on the 1970s and Abel on the 1980s. In the earlier period, political trials centered less on political violence, at that time still rare, than on the dissemination of antigovernment ideology. Given the discretionary latitude afforded judges, Lobban argues that most judgments, biased by racially motivated premises and fears, reflected a desire to criminalize "bad thoughts." By the 1980s, growing antigovernment violence shifted the legal terrain to more concrete issues of evidence and vastly multiplied the number of trials in which the alleged torture of defendants and state witnesses became a subject for judicial discretion. Going beyond a discussion of high-profile political trials, Abel also provides copiously detailed chapters on legal contests involving pass laws, censorship, forced removals, trade union rights, and draft resistance. These chapters illustrate the continuing prejudices of all but a handful of judges but also how a small number of dedicated South African human rights lawyers were able to win limited but politically

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significant victories when the Pretoria government increasingly needed to present a reformist image. In the end, both authors reach a somewhat inconclusive verdict: in South Africa's long liberation struggle, law and the courts were a major part of the problem and only a relatively small part of the solution.

The African Development Bank. BY E. PHILIP ENGLISH AND HARRIS M. MULE. Boulder: Lynne Rienner, 1996, 213 pp. $36.50 (paper, $19.95).

Established in 1963, the Abidjan-based African Development Bank has played a significant role in mobilizing development capital in an unusually harsh lending environment. This expert and candid review presents a balance sheet of the ADB's accomplishments and shortcomings and recommends ways to strengthen its comparative advantage as an institution with the indigenous expertise and rapport too often lacking among larger multilateral lenders. Challenges facing the ADB in the 1990s are legion, including the unrelenting debt burden of most African countries and growing demands for policy-based lending (making loans conditional on such nontraditional criteria as governance standards, environmental impact, and gender equity). Handicaps also plague the institution itself: inadequate research capacity, tensions between African and non-African board members, and a hands-off attitude toward project management that sometimes leaves inexperienced borrowers floundering. Nevertheless, the authors stress the bank's positive achievements in financial management and capacity-building, and urge the institution to strive for leadership in finding indigenous answers to Africa's development problems.

Africa in the New International Order: Rethinking State Sovereignty and Regional Security. EDITED BY EDMOND J. KELLER AND DONALD ROTHCHILD. Boulder: Lynne Rienner, 1996, 253 pp. $49.95 (paper, $19.95).

This uneven but generally informative collection examines the brew of problems and responses generated by civil wars in Liberia, Ethiopia, Sudan, and Somalia. Two chapters survey the implications of conflict within South Africa and its role as a regional power. To date, the mechanisms for conflict resolution within and between African countries have been weak and often ad hoc, but momentum toward stronger regional and continental institutions is real, if modest. If the economic and political marginalization of Africa can accelerate the search by African leaders for home-grown solutions to the continent's problems, many of the contributors suggest, Africans could turn today's adversity to long-term advantage.

From Protest to Challenge: A Documentary History of African Politics in South Africa, 1882–1990, vol. 5, Nadir and Resurgence, 1964–1979. BY THOMAS G. KARIS AND GAIL M. GERHART. Bloomington: Indiana University Press, 1997, 805 pp. $49.95.

The overthrow of apartheid in South Africa permits an interpretive change in the thrust of African resistance politics by the editors and authors of this invaluable documentary history. What began in 1972 as an effort to preserve a transient record of African resistance to political oppression, from its nineteenth-century origins to its apparently stalled condition in the mid-1960s, can now offer a de-

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tailed account of an epic story in our time. The text, which takes up half the volume, is organized into thematic essays written by the volume editors, who are well-known scholars of South African political history. Included is an essay on trade unions by labor expert David Lewis. This volume covers the period from the trial and imprisonment of Nelson Mandela to the government crackdown after the 1976 Soweto uprising. The authors survey movements and groups both cooperating and competing with the African National Congress. The unofficial documentary records—interviews, a diary, prison memos, handbills—are a fascinating glimpse into a large collection available on microfilm.

HARVEY GLICKMAN

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Letters to the Editor

Louis Kraar on Hong Kong, Pedro-Pablo Kuczynski on Latin America, James G. Speth on the Marshall Plan, and others

DON'T HOLD YOUR BREATH

To the Editor:

Skepticism is both an essential tool and an occupational hazard for journalists, yet Frank Ching willingly suspends his disbelief when it comes to China's treatment of Hong Kong ("Misreading Hong Kong," May/June 1997). As a result, he seriously misreads both the Western media and the clear trend in Hong Kong. Ching terms as an "aura of negativism" in the American press what is in reality the healthy skepticism of journalists in an open society.

Yes, most of the Western press is "unwilling to give China the benefit of the doubt"—an attitude that independent journalists take toward most regimes and politicians. The People's Republic of China has given the world plenty of reasons to doubt its promises, even when its self-interest is involved. Beijing recently violated an agreement with Washington by diverting for military use American production equipment that China had purchased for its civilian aircraft industry. China has offered empty pledges of local autonomy to Tibet. And the Chinese constitution guarantees rights that simply do not exist in the People's Republic. All that does not necessarily mean that China will abandon its commitments on Hong Kong, but Beijing's track record is bound to give even the most dispassionate observers pause.

Beijing's promises of a high degree of autonomy for Hong Kong are already being diluted and threatened. Ching says that there "may be a rollback of civil liberties" in Hong Kong. The truth is, there has already been a "rollback": Beijing has ordered a revision of laws that allow public demonstrations and political association without government approval. Contrary to Ching's soothing statement that Hong Kong takes a generally relaxed view of the political transition, many of its people clearly worry about changes proposed by Tung Chee-hwa, the chief executive–designate, whose popularity plunged when he gave ground on civil liberties.

Hong Kong is supposed to gain an unprecedented postcolonial status as a largely self-governing special administrative region of China. The Joint Declaration signed by China and Britain in 1984 provided that the people of Hong Kong would elect both their chief executive and their legislature. Nothing in the agreement or in the Basic Law, the constitution Beijing has written for Hong Kong, sanctions an appointed "provisional" legislature. But China created one anyway, leaving Hong Kong with both a legitimately elected legislature and an appointed one that meets across the

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border in Shenzhen, China. Ching rationalizes this by observing that 33 of the 60 members of the provisional body are members of the real legislature. What he fails to add is that the provisional legislature includes members who competed for but failed to win seats in the elected legislature—and excludes Martin Lee's Democrats, who won a majority of seats.

The main features of Hong Kong's system, which are supposed to be preserved under the "one country, two systems" formula, include the rule of law, honest administration, minimal government interference in people's lives and businesses, and an openness to information and ideas. By tinkering with the system, China puts Hong Kong's special strengths at risk. Alarmingly, Hong Kong's business elite seems more concerned about pacifying Beijing than defending the basic liberties that underpin a free economy. But the more Hong Kong looks and acts like any other city in China, the more international credit rating agencies and financial institutions will assign Hong Kong the same country risks as the rest of China. In short, diluting the city's freedoms—or merely appearing to do so—could have a highly negative effect on its business environment.

For all his optimism, Ching gives a nod toward the skeptics' greatest concern—the impression that China thinks the law is whatever it claims it to be. Ching also points out—rightly—that Beijing's authoritarian attitude makes it difficult for it not to interfere in Hong Kong. It is hard to understand how he can ignore his own evidence and reach such rosy conclusions.

LOUIS KRAAR
Member, Board of Editors, Fortune

TWO STEPS BEHIND

To the Editor:

Richard Bernstein and Ross H. Munro claim that the Persian Gulf War convinced the Chinese military to procure high-tech weapons systems, as illustrated by their continuing nuclear testing and ballistic missile programs ("The Coming Conflict with America," March/April 1997). Nuclear warheads and ballistic missiles, however, are 50-year-old technologies that played almost no role in the U.S.-led victory over Iraq. Moreover, China's development of ballistic missile technology began in 1985-86, not after the Gulf War. Most important, when Chinese leaders made the decision to stop testing and signed the Comprehensive Test Ban Treaty—an event that Bernstein and Munro fail to note—they did so despite claims by the People's Liberation Army that more tests were "required." That decision, a watershed in Chinese arms control behavior, flies in the face of claims that the PLA always gets what it wants.

The most important advances of the Gulf War did not involve the use of ballistic missiles, but rather the integration of conventional weapons and an array of supporting surveillance and command-and-control technologies to create a vast, lethal network of sensors and weapons. Recent evidence suggests that the PLA does not understand those advances any better than Bernstein and Munro.

Taiwan and other U.S. allies in the region, however, have quickly learned the lessons of the Gulf and are already integrating new technologies into their conventional forces. While the PLA has convinced Beijing to allow the import of foreign weapons systems, those systems

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are still bought in the smallest quantities required to secure technology transfer for domestic weapons manufacturers, whose products will be of inferior quality pending greater reform of the military production sector. Beijing, in short, still operates on the assumption that major war is unlikely for a matter of decades.

As for the PLA, it shows precious little understanding of what is known in the United States as the "revolution in military affairs," and is far from being able to execute combined arms operations, even in exercises without an enemy. Such shortcomings make it extremely unlikely that the PLA could win a war across the Taiwan Strait, even with minimal American involvement. Finally, should China choose to initiate a conflict, it is unlikely to do so before the return of Hong Kong and Macao, by which time Taiwan will have an even greater military advantage.

ERIC ARNETT
Project Leader, Stockholm International Peace Research Institute

TOWN AND COUNTRY

To the Editor:

While Anita Chan and Robert A. Senser do an admirable job documenting the hardships facing China's workers, they fail to distinguish between different sectors of the Chinese economy ("China's Troubled Workers," March/April 1997). Given the precarious state of the country's reform drive, their proposal to grant greater power to organized labor does a disservice to China's working class.

Since 1978, economic reforms have dramatically reduced the privileges of the urban work force in China, both by relaxing controls on internal migration—thus allowing more peasants from the country to move into major cities—and by allowing the development of private and semiprivate enterprises in rural areas. As a result, millions of peasants have the chance to join the industrial work force for the first time.

The growth of the non-state sector has brought enormous benefits to the countryside but at a substantial cost to many urban workers. Although Chan and Senser fail to acknowledge the point, the intense competitive pressures that lead urban textile enterprises to impose draconian "scientific management" come largely from smaller collective and foreign owned textile mills that pay much less to a work force of rural origin. We may sympathize with the employees of state firms chafing under tighter discipline, but their complaints are those of a declining labor aristocracy.

Under these circumstances, Chan and Senser's call for more trade union autonomy in China is difficult to justify. Greater freedom of association will do little for unskilled workers in the non-state sector, where wages are lowest and working conditions most hazardous. Given their rural origins and often transient status, such workers would have virtually no leverage even with collective bargaining. Skilled urban workers in urban state enterprises, on the other hand, are in greater demand and would be in a far better position to press their grievances. Any premature liberalization of existing labor laws would thus strengthen the hand of urban employees demanding subsidies for loss-making state firms at the expense of the rural majority.

Official moves to permit trade union pluralism may be appropriate once the state sector is dismantled. China's most

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exploited workers, however, are much more likely to benefit from effective regulation of the labor market, accompanied by relaxation of internal migration restrictions and privatization of state-owned firms. Such changes are precisely what the urban labor force would lobby against if it received greater autonomy.

JEFF RIGSBY
Researcher and Writer, The Economist Intelligence Unit, Hong Kong

ENVIRORATIONAL

To the Editor:

In discussing the environmental movement, James P. Pinkerton dances coyly around the question of values, focusing on what is, not what ought to be ("Enviromanticism," May/June 1997). One is left to read between the lines. The title neologism, for instance, insinuates that environmentalism is fanciful and emotional as opposed to rational and pragmatic. If intended, however, that implication is nonsensical. For as axioms are to mathematics, so are values to political discourse. Reason provides the girders but not the foundation. All policy prescriptions derive from pre-rational beliefs. Environmentalists are distinguished not by their romanticism or their reason, but by the relative importance they assign to values widely shared.

What values motivate environmentalists? I would list three, all fairly conventional: the sanctity of human health, the importance of private property, and the belief that the natural world is beautiful and worth preserving. Perhaps Pinkerton would consider the first two grounded and rational since they appeal to self-interest. They explain why environmentalists feel it is just about as wrong to deliver lead to a child's brain through a tailpipe as through the barrel of a gun, why we are no more sanguine about the damage done to buildings by acid rain than by vandals. In that light, is it really any more romantic for environmentalists to call for leadership at all levels of government to combat environmental problems than to combat crime?

Pinkerton may consider my third environmental value romantic, for it has less to do with selfishness than with a vision of the good society. But if it is romantic, then so are many other values that are rarely questioned in *Foreign Affairs*. Can democracy, for example, really be justified by "rational" appeals to self-interest? Is it the surest path to collective wealth? Besides, wouldn't a utilitarian rationale ring hollow in the ears of most Americans? Perhaps Pinkerton would label the Founding Fathers, creatures of the Age of Reason, "democromantics." If so, I am happy to join their company.

DAVID MALIN ROODMAN
Senior Researcher, Worldwatch Institute

PUSH ME, PULL YOU

To the Editor:

Jeffrey E. Garten is correct that unilateral trade embargoes are usually ineffective, but reinventing the boycott could allow policymakers to sting outlaw nations without crippling innocent corporations ("Business and Foreign Policy," May/June 1997). The key problem with current embargoes is that they highlight export controls. We need to redesign sanctions to focus on import controls. Such a reform would dramatically improve the economics involved: U.S. corporations would no longer be crippled by lost sales, and given the leverage

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of American markets, even a unilateral embargo could be effective.

THOMAS O'BRIEN

Director for Research, Horizon Institute for Policy Solutions

NEWS TO ME

To the Editor:

Garrick Utley writes as though there was once a golden age of foreign correspondence, after which international news coverage steadily declined ("The Shrinking of Foreign News," March/April 1997). But America's attention to international affairs has always waxed and waned. For better or worse, Americans care about foreign affairs only when those affairs are clearly relevant to their well-being or status in the world, as when American sons and daughters are in harm's way. In its short history, television coverage of foreign affairs has also waxed and waned. Vietnam was a peak, followed by a trough as news minutes were spent on Watergate, the long lines at gas stations, and the recession. Iranians' seizure of the American embassy sent coverage minutes skyrocketing and even spawned a whole new news program, ABC's *Nightline*. Then attention waned once again until 1989-90, when the Berlin Wall fell and preparations for the Persian Gulf War began. (Incidentally, by choosing 1989 as a base year for proving the recent decline of coverage minutes, Utley has effectively pulled a fast one on us, since 1989 was a time of unusually high foreign news coverage.) Claiming that "broad viewer interest in world affairs is declining from its modest Cold War heights" obscures the wavering television coverage that so neatly coincides with the American proclivity for self-absorption.

Utley also mischaracterizes the role of the foreign correspondent. To put it crudely, there seem to be two models. The earlier model, which Utley seems to favor, is not so much a reporter as a "storyteller." He or she chooses the story, produces the report, selects the subjects to interview and the clips to use, and offers analysis throughout. In sum, the storyteller offers viewers a coherent interpretation of the event he or she is covering.

At the other end of the spectrum is the "new" or "gonzo" approach to journalism. Hunter S. Thompson, perhaps the best-known advocate of this approach, described the reporter's role as that of a walking camera: the reporter simply points his eyes in various directions, records what he sees, and then passes it all on to readers and viewers. There is no analysis, just observations. CNN's live coverage of Yeltsin's troops laying siege to the Russian parliament is perhaps the best recent example.

Each approach has its strengths and weaknesses. By disparaging the latter approach and waxing nostalgic over the former, Utley confuses style with content. The truthfulness of the broadcast, which is the supreme good, depends not on the way the report is delivered but on the content: on getting the facts right, trying to show all facets of the matter, and keeping opinion out of the broadcast. Today's television coverage of foreign affairs may not be perfect. But has it ever been?

KEVIN R. KOSAR

Doctoral Candidate in Politics, New York University

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THINK LOCALLY, ACT LOCALLY

To the Editor:

The recent articles on Latin America by Jorge I. Domínguez and Michael Pettis contain many keen and valid insights with which few observers of Latin America would quarrel ("Latin America's Crisis of Representation," January/February 1997, and "The Liquidity Trap," November/December 1996). Each in its own way, however, represents an insular point of view.

Pettis rightly warns that deregulation, trade liberalization, and privatization are not enough to guarantee economic growth. But who said they were? Pettis rails against an oversimplified picture manufactured by, among others, successful Wall Street traders who made money on Brady bonds once Latin American countries were able to settle their debts. Nor are his comparisons of the present with the well-known boom-and-bust cycles of nineteenth century economic history accurate. Latin American economies are growing at a rapid clip—from GDP of $135 billion for the seven largest economies in 1993 to a projected $250 billion in 1997—and two-thirds of their growth comes from volume increases, not a price boom.

For his part, Domínguez yearns for the old institutional solutions to centralized democracy: trade unions, political parties, party discipline, coalitions, and romantic guerrillas who become politicians in their waning years. But such solutions ignore the changes that the information revolution has brought to political life. Voters everywhere care about their jobs and the state of the economy, not political parties or legislative change—hence President Fujimori's popularity in Peru even after his April 1992 decision to disband Congress.

The elements of democracy that are missing in Latin America are effective elected local government, a properly functioning civil service, and an impartial and incorruptible judiciary. These are far more pressing concerns than constitutions that no one reads and congresses that seem far removed from daily life.

PEDRO-PABLO KUCZYNSKI
Chief Executive Officer, The Latin America Enterprise Capital Corporation

MARSHALL'S LIVING LEGACY

To the Editor:

One lasting effect of the Marshall Plan worth noting on its fiftieth anniversary is its approach to development aid, which lives on at the United Nations Development Programme ("The Marshall Plan and Its Legacy," Special Commemorative Section, May/June 1997). Paul Hoffman, who became the first administrator of UNDP after heading the Marshall Plan's Economic Cooperation Administration, pioneered the twin concepts of forging mutually beneficial relationships between businesspeople and economists and requiring countries receiving aid, no matter how poor, to contribute. Both the importance of private enterprise as an engine of development and the principle of counterpart national funds are now established at UNDP, the world's largest single source of grant-based multilateral assistance for sustainable human development.

Development aid works. Average life expectancy in the developing world has increased by more than 33 percent in the last 30 years. Over 70 percent of the people in developing countries now have some access to health services. Primary

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school enrollment has increased to more than 80 percent worldwide.

But much of the developing world is not making it. Over a hundred countries are worse off today than they were 15 years ago. Each year, between 13 and 18 million people, mostly children, die from hunger and poverty-related causes. That adds up to some 1,700 human beings an hour, with only 10 percent or 15 percent caused by emergencies. By 2000, half the people in sub-Saharan Africa will be living on incomes equal to less than $1 a day.

In the spirit of the Marshall Plan, here are four principles, organized around achievable objectives, for improving the payoff of development aid. First, the decline in development aid must be reversed. That, however, can happen only with strong political support. Second, the main indicator of development assistance's success should be a declining number of recipients. Slowly but steadily, countries must move off the list of aid recipients as their prospects improve. Third, as countries move off the list, aid should be targeted to the neediest countries, and to the neediest people in those countries. Fourth, different types of development assistance should be more clearly differentiated, from short-term rehabilitation efforts following crises and conflicts, to initiatives to manage global problems, to long-term aid to the poorest countries. A nuanced understanding would help focus attention on progress in each category and greatly enhance political interest in development assistance as a whole.

The world looks to the United States to restore its commitment to development assistance and increase its aid, but also to better target aid and otherwise make it more efficient. Today U.S. levels of official development assistance hover around 0.12 percent of GNP. Surely there is room for improvement. There is still a need for the spirit of generosity, the political realism, and the cooperation that made the Marshall Plan possible.

JAMES G. SPETH
Administrator, United Nations Development Programme

NOTE FROM THE EDITORS:

Several readers have called to say that Winston Churchill applied the description "the most unsordid act in history" not to the Marshall Plan but to the Lend-Lease program. So he did, in *Their Finest Hour*. But Dean Acheson, for one, in his *Sketches from Life*, cites Churchill using the same phrase for the Marshall Plan, and standard reference works on American foreign policy dating back to the 1950s similarly describe the postwar European Recovery Program in Churchill's words. Perhaps with the foreshortening of half a century's retrospect, the late British statesman would accept the use of his felicitous phrase for the entire American aid effort to Europe of the 1940s—Lend-Lease during the war, the Marshall Plan after.

PETER GROSE
Editor, "The Marshall Plan and its Legacy," Special Commemorative Section, Foreign Affairs, *May/June 1997*

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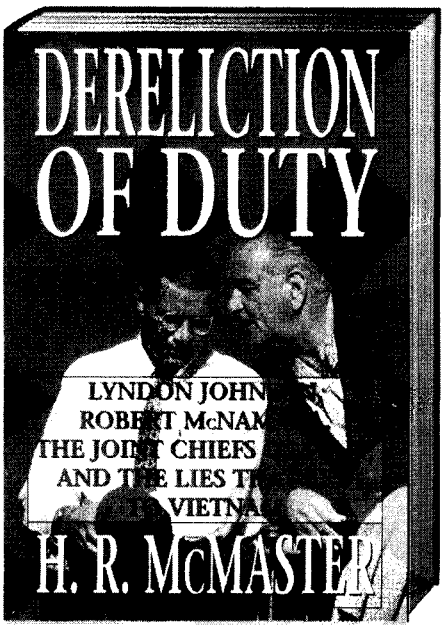

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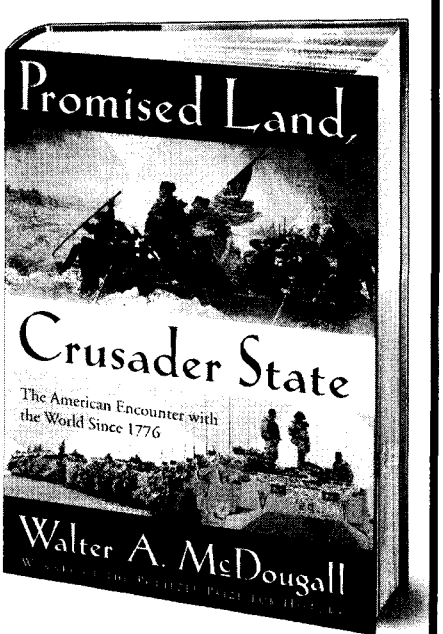

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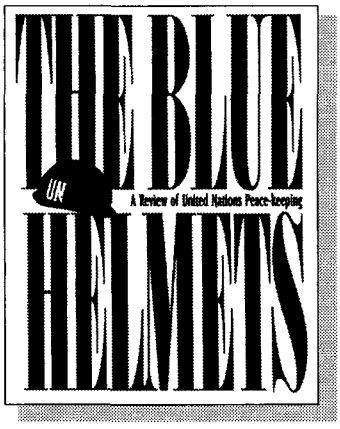

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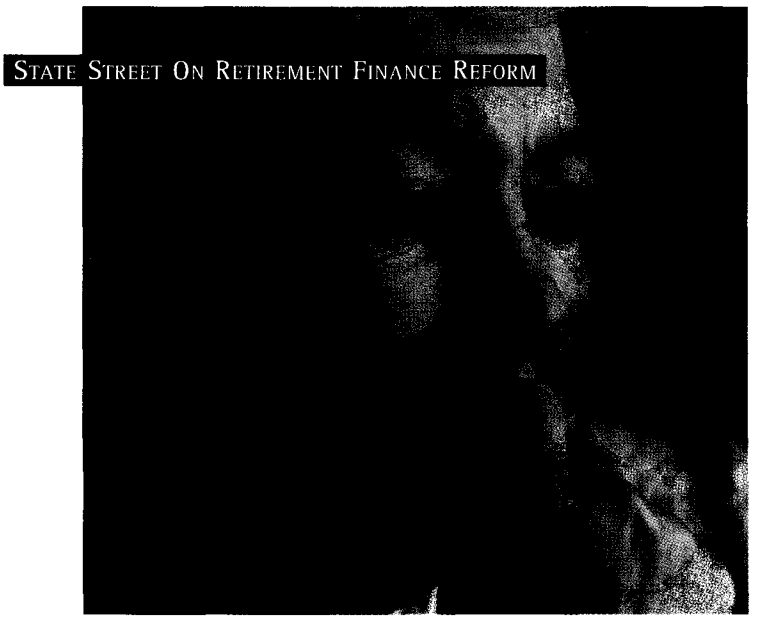

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